Arbitrator Selection at the NASD: Investor Perception of a Pro-Securities Industry Bias

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I. INTRODUCTION

Both investors and Congress have expressed concern about the fairness of securities industry-sponsored and administered arbitral forums.[1] It is important to the legitimacy of any nonjudicial forum that it be perceived by the participants as fair to all parties.[2] If fairness is a concern, the arbitral forum's existence as a viable alternative dispute resolution mechanism will be undermined.

Disputes between investors and the securities industry generally are resolved through arbitration.[3] In order to open a securities brokerage account, investors usually are required to sign an agreement requiring them to resolve all disputes through arbitration.[4] This same agreement generally requires that arbitration proceedings between investors and members of the

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[1] *See* ARBITRATION POLICY TASK FORCE, NATIONAL ASS'N OF SEC. DEALERS, INC., SECURITIES ARBITRATION REFORM: REPORT OF THE ARBITRATION POLICY TASK FORCE TO THE BOARD OF GOVERNORS 93 (1996) [hereinafter ARBITRATION POLICY TASK FORCE]; GENERAL ACCOUNTING OFFICE, SECURITIES ARBITRATION: HOW INVESTORS FARE: REPORT TO CONGRESSIONAL REQUESTERS 4 (1992); Public Investors Arbitration Bar Ass'n, Petition to the Securities and Exchange Commission 4–5, 10 (Oct. 1997) (unpublished manuscript, on file with author) [hereinafter PIABA].

[2] *See* 1.1 NATIONAL ASS'N OF SEC. DEALERS, INC., ARBITRATOR TRAINING: PANEL MEMBER COURSE PREPARATION GUIDE vii (1996); THE ARBITRATOR'S MANUAL 1 (1996); Constantine N. Katsoris, *The Arbitration of a Public Securities Dispute*, 53 FORDHAM L. REV. 279, 308 (1984).

[3] *See, e.g.*, Rodriguez de Quijas v. Shearson/American Express, Inc., 490 U.S. 477, 478 (1989); Shearson/American Express, Inc. v. McMahon, 482 U.S. 220, 223 (1987); *see also* ARBITRATION POLICY TASK FORCE, *supra* note 1, at 6; GENERAL ACCOUNTING OFFICE, *supra* note 1, at 4; Constantine N. Katsoris, *SICA: The First Twenty Years*, 23 FORDHAM URB. L.J. 483, 486 (1996).

[4] *See* David A. Lipton, *Mandatory Securities Industry Arbitration: The Problem and the Solution*, 48 MD. L. REV. 881, 885 (1989); *see also* ARBITRATION POLICY TASK FORCE, *supra* note 1, at 6.

securities industry must be conducted in an arbitral forum sponsored, controlled, and administered by the securities industry,[5] rather than an independent arbitral forum such as the American Arbitration Association (AAA).[6] Most of the securities arbitration proceedings between investors and members of the securities industry are conducted in the arbitral forum sponsored and administered by the only registered securities industry association in the United States, the National Association of Securities Dealers, Inc. (NASD).[7] In 1997, 5,997 arbitration cases were filed with the NASD.[8]

According to Mary Schapiro, President of NASD Regulation, Inc. (NASDR), the NASD arbitral forum is "committed . . . to serve as . . . a process that is *fair to all parties*."[9] One of the hallmarks of a fair arbitral forum is the ability of both parties to equally participate in the selection of

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[5] *See* Lipton, *supra* note 4, at 884; *see also* ARBITRATION POLICY TASK FORCE, *supra* note 1, at 6.

[6] The AAA is a

> public service, not-for-profit organization dedicated to helping manage conflict through a variety of dispute resolution techniques . . . . It provides a forum for the hearing of disputes, tested rules and procedures that have broad acceptance, case administration services, and a roster of high caliber, impartial experts to hear and resolve cases.

AMERICAN ARBITRATION ASS'N, ELEMENTS OF CHANGE: ANNUAL REPORT 14 (1995).

[7] *See* ARBITRATION POLICY TASK FORCE, *supra* note 1, at 7. The NASD is registered pursuant to section 15A of the Securities and Exchange Act of 1934, 15 U.S.C. § 78o-3 (1994). It is a self-regulatory organization (SRO) and is funded exclusively by its membership, which includes virtually every broker or dealer in the United States that conducts a securities business with the public. *See* NATIONAL ASS'N OF SEC. DEALERS, INC., NASD MANUAL 151 (1999). The NASD has delegated its responsibility for managing and administering its securities arbitration forums to its wholly-owned subsidiary, NASD Regulation, Inc. (NASDR). The NASDR was created in January 1996 to provide regulation and member and constituent services, with the NASD retaining general oversight responsibility for the effectiveness of the self-regulatory and business operations of the NASD along with final policymaking authority. *See id.*

[8] *See* National Ass'n of Sec. Dealers Regulation, *NASD Regulation Statistics* (last modified Jan. 20, 1999) <http://www.nasdr.com/2380.htm>; *see also* PIABA, *supra* note 1, at 2.

[9] Mary L. Schapiro, *Owen Distinguished Lecture Series, Vanderbilt University, Nashville, Tennessee, April 3, 1996* (visited Oct. 16, 1999) <http://www.nasdr.com/1420/schapiro_01.htm> (emphasis added).

the decisionmaker, i.e., the arbitrator.[10] This is especially important where arbitrators are not appointed by a party perceived as neutral.[11]

Prior to November 17, 1998, investor perception that the NASD arbitrator selection process was biased in favor of the securities industry was reasonable because the NASD appointed arbitrators to serve on panels from its pool of arbitrators with almost no input by the parties.[12] This process was problematic because it meant that arbitrators were appointed by only one of the parties to the dispute—the securities industry. Investors required to use the NASD arbitral forum felt that they were not treated fairly in this securities industry-sponsored arbitral forum because they perceived arbitrators selected primarily by the NASD as biased in favor of the securities industry.[13] In a 1996 report to the NASD, the Arbitration Policy Task Force to the Board of Governors[14] of the NASD (NASD Task Force)[15] found that "participants [were] concerned that the selection process reflect[ed NASD] staff bias and prejudgment . . ."[16] and that "the

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[10] *See* 3 IAN MACNEIL, FEDERAL ARBITRATION LAW: AGREEMENTS, AWARDS, AND REMEDIES UNDER THE FEDERAL ARBITRATION ACT § 27:3 (1995 & Supp. 1997); *see also* McConnell v. Howard Univ., 818 F.2d 58, 68 n.12 (D.C. Cir. 1987) (refusing to enforce an arbitration agreement that designated an arbitration panel institutionally linked to or chosen by one party, especially if that party drafted the underlying agreement); Rosenberg v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 995 F. Supp. 190, 209 (D. Mass. 1998), *aff'd*, 163 F.3d 53 (1st Cir. 1998), *superseded by* 170 F.3d 1 (1st Cir. 1999); ROBERT M. RODMAN, COMMERCIAL ARBITRATION WITH FORMS § 9.3, at 237 (1984).

[11] *See McConnell*, 818 F.2d at 68 n.12; *Rosenberg*, 995 F. Supp. at 209.

[12] *See* NASD CODE OF ARBITRATION PROCEDURE Rules 10302(f), 10308, 10309, 10311 (National Ass'n of Sec. Dealers, Inc. 1997) (amended 1998); *see also* ARBITRATION POLICY TASK FORCE, *supra* note 1, at 93; David A. Lipton, *Discovery Procedures and the Selection and Training of Arbitrators: A Study of Securities Industry Practices*, 26 AM. BUS. L.J. 435, 438 (1988).

[13] *See* ARBITRATION POLICY TASK FORCE, *supra* note 1, at 93; GENERAL ACCOUNTING OFFICE, *supra* note 1, at 4 n.6; PIABA, *supra* note 1, at 4, 10.

[14] The Board of Governors is the governing board of the NASD. *See* NATIONAL ASS'N OF SEC. DEALERS, INC., *supra* note 7, at 1012.

[15] In September 1994, the NASD appointed an Arbitration Policy Task Force to study its securities arbitration process and to make suggestions for its reform. The NASD Task Force had eight members with various backgrounds in securities arbitration. NASD Task Force members were the following: David S. Ruder, Linda D. Fienberg, John W. Bachmann, Stephen J. Friedman, Stephen L. Hammerman, J. Boyd Page, Francis O. Spalding, and Richard E. Speidel. *See* ARBITRATION POLICY TASK FORCE, *supra* note 1, at 3-4.

[16] *Id.* at 93.

arbitration process [was] industry controlled."[17] The NASD Task Force specifically noted that "[t]he selection of arbitrators for a case should avoid even the appearance of impropriety . . . [and that] the NASD's current procedures for arbitrator selection and disqualification in [investor-industry] disputes [did] not meet this test."[18]

In contrast to arbitral norms and practice,[19] the NASD exercised a predominant role in determining the composition of the pool of available arbitrators[20] and in appointing the arbitrators who would hear the particular dispute between the investor and member of the securities industry.[21] To effectively address the issue of perceived bias in favor of the securities industry in the NASD's arbitrator selection process, the NASD Task Force recommended that the NASD adopt a list selection method for choosing arbitrators.[22]

In response to investor perception of a pro-securities industry bias and NASD Task Force recommendations, the NASD implemented a list selection method for selecting arbitrators in its arbitral forum effective November 17, 1998. The NASD, along with the United States Securities and Exchange Commission (Commission),[23] contends that these new procedures for appointing arbitrators effectively address the issue of investor perceived bias in favor of the securities industry in the NASD arbitrator selection process.

With the massive movement of Americans into the securities markets, the mechanism used to resolve disputes between investors and members of the securities industry is becoming increasingly important. Americans,

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[17] *Id.* at 94.

[18] *Id.*

[19] Arbitral norms and practices require that arbitrators be impartial and independent of the parties before them. *See* Gaer Bros. v. Mott, 130 A.2d 804, 807 (Conn. 1957); American Eagle Fire Ins. Co. v. New Jersey Ins. Co., 148 N.E. 562, 564 (N.Y. 1925); George A. Fuller Co. v. Albin Gustafson Co., 390 N.Y.S.2d 416, 417 (N.Y. App. Div. 1977); Thomas v. Howard, 276 S.E.2d 743, 745 (N.C. Ct. App. 1981).

[20] *See* NASD CODE OF ARBITRATION PROCEDURE Rule 10102(a) (National Ass'n of Sec. Dealers, Inc. 1997) (amended 1998).

[21] *See id.* Rules 10302, 10308 (amended 1998).

[22] *See* ARBITRATION POLICY TASK FORCE, *supra* note 1, at 94–97.

[23] All NASD rules governing securities arbitration must be approved by the Commission, an independent, nonpartisan, quasi-judicial agency charged with the responsibility of regulating the U.S. securities markets. *See* Securities Exchange Act of 1934, §§ 15A, 19, 15 U.S.C. §§ 78o-3, 78s (1999).

more than ever before, are responsible for their own financial security and are relying on the financial markets to generate retirement income, to educate their children, and to produce savings. Assets of mutual funds of all types have grown from $371 billion in 1984 to more than $5 trillion.[24] This trend most likely will continue. Even President Clinton is relying on investing in the securities markets to shore up Social Security. In his State of the Union address, the President recommended setting up Universal Savings Accounts that would allow workers to invest in stock and bond mutual funds to supplement Social Security benefits.[25]

The purpose of this Article is to assess carefully whether the new arbitrator selection rules effectively address the issue of investor perceived bias in favor of the securities industry in the NASD arbitrator selection process. First, the Article will briefly discuss the history of NASD sponsored securities arbitration focusing on the method used to select arbitrators. Second, it will evaluate the arbitrator selection method used by the NASD prior to the implementation of the current list selection method; this is important to any analysis of the new arbitrator selection rules because only the arbitrator selection rules governing the appointment of arbitrators to serve on panels were amended. Third, it will describe the new list selection method and evaluate whether it sufficiently addresses the issue of investor perceived bias in favor of the securities industry in the NASD arbitrator selection process.

II. HISTORY OF NASD-SPONSORED ARBITRATION

A. *Background*

Prior to 1987, arbitration was not a legitimate mechanism for resolving disputes between investors and the securities industry. In *Wilko v. Swan*,[26] the Court reasoned that predispute arbitration agreements violated the policy of investor protection stated in the Securities Act of 1933 (Securities Act) because such agreements required investors to waive their statutory

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[24] *See* Brian Reid & Kimberlee Miller, *Mutual Fund Developments in 1998*, PERSP., Feb. 1999, at 1, 2.

[25] *See* President William Jefferson Clinton, *State of the Union Address, Jan. 19, 1999* (visited Oct. 16, 1999) <http://www.whitehouse.gov/WH/New/html/19990119-2656.html>.

[26] 346 U.S. 427 (1953), *overruled by* Rodriquez de Quijas v. Shearson/American Express, Inc., 490 U.S. 477, 485 (1989).

right to a judicial remedy.[27] However, in 1987, the Court determined in *Shearson/American Express, Inc. v. McMahon*[28] that arbitration was an adequate substitute for judicial resolution of disputes between investors and the securities industry; the Court reasoned that the mistrust of arbitration that formed the basis for the *Wilko* decision was no longer applicable because, since the 1975 amendments to section 19 of the Exchange Act, the Commission "has had expansive power to ensure the adequacy of the arbitration procedures employed by the SROs [including the NASD]"[29] and that "where the [Commission] has sufficient statutory authority to ensure that arbitration is adequate to vindicate Exchange Act rights, . . . agreements to arbitrate Exchange Act claims"[30] are enforceable. Two years later, the Court expressly overruled *Wilko* in *Rodriquez de Quijas v. Shearson/American Express, Inc.*,[31] holding that predispute arbitration agreements were enforceable in claims arising under the Securities Act. After *McMahon* and *Rodriguez*, most securities disputes between investors and brokers or dealers are now arbitrated under mandatory predispute arbitration agreements.[32]

However, in 1992, Congress became concerned about whether securities industry-sponsored arbitration is fair to investors. "A primary concern is that arbitration at an industry-sponsored forum may have a pro-industry bias."[33] This issue was especially pressing because the member brokerage firm could refuse to open a securities brokerage account for an investor if she refused to sign a predispute resolution agreement requiring

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[27] Although the *Wilko* holding only involved the Securities Act, most courts also applied its holding to agreements to arbitrate future disputes arising under the Securities Exchange Act of 1934 (Exchange Act). *See, e.g.*, Mansbach v. Prescott, Ball & Turben, 598 F.2d 1017, 1030 (6th Cir. 1979) (holding that the arbitration agreement was overridden by antiwaiver provision of federal securities laws); Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Moore, 590 F.2d 823, 827-29 (10th Cir. 1978) (same); Weissbuch v. Merrill Lynch, Pierce, Fenner & Smith, Inc. 558 F.2d 831, 835 (7th Cir. 1977) (same); Ayres v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 538 F.2d 532, 536 & n.121 (3d Cir. 1976) (same); Newman v. Shearson, Hammill & Co., 383 F. Supp. 265, 268 (W.D. Tex. 1974) (same).

[28] 482 U.S. 220 (1987).

[29] *Id.* at 233.

[30] *Id.* at 238.

[31] 490 U.S. 477 (1989).

[32] *See* GENERAL ACCOUNTING OFFICE, *supra* note 1, at 19; Katsoris, *supra* note 3, at 483.

[33] GENERAL ACCOUNTING OFFICE, *supra* note 1, at 4.

her to arbitrate all future disputes. As a consequence, Congress[34] asked the General Accounting Office (GAO) to, among other things, analyze the results of securities arbitration at industry-sponsored forums (including the NASD) and to compare these results with those of the AAA, the primary independent forum for securities arbitration.

The GAO found that an investor was no more likely to prevail in an independent than an industry-sponsored arbitral forum. But it recognized that its study "did not directly address the fairness of the arbitration process."[35] The GAO determined that investor confidence in arbitration depends on the investors' perceptions of the fairness and expertise of those who decide the cases—the arbitrators . . . ."[36] Moreover, it noted that even the Commission recognized that allowing investors the option of using an arbitral forum independent from the securities industry, such as the AAA, would improve investors' perception of fairness in securities arbitration.[37]

B. *NASD Code of Arbitration Procedure*

Arbitration proceedings between NASD members and investors are conducted pursuant to the NASD's Code of Arbitration Procedure (NASD Code), which is written primarily by the securities industry.[38] All NASD arbitration panels consist of one or three arbitrators and must have a majority of public arbitrators unless the parties agree to a different composition. Prior to November 17, 1998, arbitrators were appointed by a

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[34] This request was made by the Chairman of the House Committee on Energy and Commerce and its Subcommittee on Telecommunications and Finance, and the Chairman and four members of the Senate Committee on Banking, Housing, and Urban Affairs. *See* GENERAL ACCOUNTING OFFICE, *supra* note 1, at 4.

[35] *Id.* at 6.

[36] *Id.* at 55.

[37] *See id.* at 60. Although the GAO findings were applicable to all securities industry arbitral forums, they were especially relevant to the NASD arbitral forum in light of the fact that most arbitration proceedings between investors and member firms are conducted in the NASD arbitral forum.

[38] *See* NATIONAL ASS'N OF SEC. DEALERS, INC., *supra* note 7, at 7511. The NASD Code is based on the Uniform Code of Arbitration developed by the Securities Industry Conference on Arbitration (SICA). SICA is composed predominantly of representatives from SROs and the Securities Industry Association but has four public members. *See* Katsoris, *supra* note 2, at 314; *see also* SECURITIES INDUS. CONFERENCE ON ARBITRATION, SECURITIES INDUSTRY CONFERENCE ON ARBITRATION REPORT NUMBER SIX 1, 5-12 (1989) (setting forth the most recent version of the Uniform Code of Arbitration).

member of the NASD staff or the Director of Arbitration, or, in arbitrations involving large and complex cases, were chosen using a method designated by the parties.[39] All arbitrators appointed to panels were selected from the NASD pool of arbitrators, which was established and maintained by the National Arbitration and Mediation Committee of the Board of Governors of the NASD.[40] Arbitrators were classified as either public (not from the securities industry)[41] or securities industry arbitrators (either employed by or retired from the securities industry or representing securities industry clients)[42] in the NASD arbitrator pool. The NASD Code permitted the Director of Arbitration to use his or her discretion in selecting arbitrators from the NASD arbitrator pool.[43]

In January 1996, the NASD Task Force determined, among other things, that investors were concerned that the NASD staff exercised too much influence in the composition of the arbitration panels. Specifically, the NASD Task Force found the following: (1) investors were "concerned

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[39] *See* NASD CODE OF ARBITRATION PROCEDURE Rules 10308, 10334 (National Ass'n of Sec. Dealers, Inc. 1997) (amended 1998). Under NASD Rule 10334 for large and complex cases, parties may allow the NASD staff to appoint the arbitrator, may use a list selection method described in subparagraph (c) of Rule 10334, or may agree upon any other method. *See id.* Rule 10334 (amended 1998).

[40] *See id.* Rule 10102. This has not changed under the new arbitrator selection rules effective November 17, 1998.

[41] A public arbitrator was defined as a person who was not from the securities industry and could not be a spouse or other member of the household of a person who was associated with a member of the NASD or other broker or dealer. *See id.* Rule 10308 (amended 1998).

[42] An individual was classified as a securities industry arbitrator if he or she was any of the following: (a) currently, or within the first three years, associated with a member of the NASD or other broker or dealer; (b) retired from a member of the NASD or other broker or dealer; (c) a professional, such as an attorney or accountant, who devoted twenty percent or more of her professional work effort to securities industry clients within the last two years; or (d) registered under the Commodity Exchange Act or a member of a registered futures association or any commodities exchange or associated with any such person. *See id.*

[43] *See id.* The NASD Director of Arbitration selected arbitrators from its pool of arbitrators "[a]fter determining the type of controversy . . . in accordance with the skills and expertise necessary to decide the case." DAVID E. ROBBINS, SECURITIES ARBITRATION PROCEDURE MANUAL § 10.4, at 10-9 (2d ed. 1996) (citing Edward W. Morris, Jr. & Deborah Masucci, *Securities Arbitration at Self-Regulatory Organizations: New York Stock Exchange, Inc. and National Association of Securities Dealers, Inc. Administration and Procedures*, *in* SECURITIES ARBITRATION 1990, at 181, 195 (PLI Corp. Law & Practice Course Handbook Series No. B4-6932, 1990)).

that the current selection process utilized by the NASD reflected staff bias and prejudgment" and therefore a pro-securities industry bias and (2) investors had "limited input on the choice of arbitrators" on the panel.[44] It also noted that under the arbitrator selection process in effect prior to November 17, 1998, "for investors and their counsel, the current procedure further reinforces their perception that the arbitration process is industry controlled."[45] Noting that the selection of arbitrators for a case should avoid even the appearance of impropriety and based on comments received indicating that the NASD's arbitrator selection procedures prior to November 17, 1998 did not meet this test, the NASD Task Force recommended the use of a list selection method to select arbitrators.[46]

In summary, prior to November 17, 1998, the impartiality of arbitrators in the NASD's arbitral forum was rightfully called into question because of the dominant role the NASD played in determining the pool of available arbitrators, selecting from the pool of available arbitrators, and appointing arbitrators to hear claims against NASD member firms. Even though the NASD asserted that it always appointed a majority of public arbitrators, this too was questionable because the NASD wrote and implemented the rules classifying arbitrators as either public or securities industry arbitrators. Clearly, there was more than a reasonable basis for investors to perceive that the arbitrator selection process reflected a pro-securities industry bias. Moreover, given the disparity in bargaining power between investors and members of the securities industry, most investors were forced to abide by the NASD arbitrator selection rules in order to participate in the United States securities markets.

In an attempt to dispel the perception that the selection of arbitrators in the NASD arbitral forum is dominated by the securities industry, the NASD changed its rules governing the appointment of arbitrators to serve on arbitration panels effective November 17, 1998. The NASD, along with the Commission, asserts that its newly enacted arbitrator selection rules should eliminate the perception held by investors that the securities industry dominates the arbitrator selection process, resulting in arbitrator decisions biased in favor of the securities industry. An analysis of the arbitrator

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[44] ARBITRATION POLICY TASK FORCE, *supra* note 1, at 93. The NASD Task Force also found that there was a shortage of trained, available arbitrators, which intensified issues concerning the NASD arbitrator selection process. *See id.* at 11. This Article will address only issues pertaining to the selection of arbitrators.

[45] *Id.* at 94.

[46] *See id.* The NASD Task Force also recommended greater flexibility in classifying arbitrators. *See id.*

selection rules in effect prior to November 17, 1998 is necessary to determine whether this is indeed the case, i.e., whether the newly enacted arbitrator selection rules are sufficient to correct for the fact that one party (the member brokerage firm) is institutionally linked to the arbitral forum, which not only writes the rules governing the arbitrator selection process, but also controls the pool from which arbitrators are selected.

III. NASD ARBITRATOR SELECTION BEFORE NOVEMBER 17, 1998[47]

An analysis of the rules of the NASD Code governing arbitrator selection in disputes between investors and the securities industry prior to November 17, 1998, indicates a reasonable basis for the conclusion that the arbitrator selection process was dominated by the securities industry and that arbitrators were chosen primarily by one party—the securities industry. There was at least an appearance of impropriety because investors had no meaningful opportunity to participate in the arbitrator selection process.

Arbitral norms and practices require that arbitrators have no connection with the parties that might give the appearance of their not being completely impartial.[48] Moreover, "both parties to a dispute must have an equal right to control the appointment of the arbitral panel, and neither side should play a disproportionate role in the decisionmaking"[49] process. The right to appoint arbitrators to serve on the panel is almost never given to one side;[50] some courts have refused to enforce arbitration agreements that

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[47] All references to NASD Rule 10308 in this Part refer to NASD Rule 10308 in effect prior to November 17, 1998.

[48] *See* RODMAN, *supra* note 10, § 9.9, at 244; *see also* THE ARBITRATOR'S MANUAL, *supra* note 2, at 3.

[49] Rosenberg v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 995 F. Supp. 190, 208 (D. Mass. 1998).

[50] *See Development in the Law—Employment Discrimination*, 109 HARV. L. REV. 1670, 1686 (1996); *see also* SEC. ARBITRATION Rule 14 (American Arbitration Ass'n 1993); George H. Friedman, *The New Securities Arbitration Rules of the American Arbitration Association*, *in* SECURITIES ARBITRATION 1993: PRODUCTS, PROCEDURES, AND CAUSES OF ACTION, at 23, 27 (PLI Corp. Law & Practice Course Handbook Series No. B4-7036, 1993); Carole Silver, *Models of Quality for Third Parties in Alternative Dispute Resolution*, 12 OHIO ST. J. ON DISP. RESOL., 37, 53 (1996).

designate a panel institutionally linked to or chosen by one party, especially if that party drafted the underlying agreement.[51]

But this one-sided control of the panel was exactly the case in disputes between investors and members of the securities industry prior to November 17, 1998. One party, the member brokerage firm, dominated the weaker party, the investor. In order to participate in the United States securities markets, most investors were required to sign an agreement to arbitrate future disputes with the member brokerage firm. Furthermore, this mandatory predispute agreement was drafted by the member brokerage firm. Finally, the member brokerage firm was a paying member of the institution (the NASD) that administered and controlled the arbitral forum and wrote the rules governing the selection of arbitrators. As a result, arbitrator selection procedures under the NASD Code could not meet minimal standards of arbitral independence.

Securities industry domination and control began very early in the process, with the composition of the arbitrator pool from which the Director of Arbitration appointed arbitrators, and continued throughout the appointment process.[52] The NASD determined who was appointed from the pool to decide disputes between its members and investors. It also determined who was admitted to the pool of arbitrators from which arbitrators were selected to serve on panels.

Although the NASD Code required that the majority of arbitrators serving on a panel be public arbitrators, i.e., not from the securities industry, the classification of the arbitrators in the NASD pool as public arbitrators or securities industry arbitrators was performed solely by the NASD pursuant to rules prescribed in the NASD Code.[53] This practice continues under the newly enacted arbitrator selection rules, and the classification rules remain basically the same. In other words, the newly enacted arbitrator selection rules primarily focus on the rules governing the appointment of arbitrators to serve on arbitration panels; they do not remove the nexus of control of the composition of the arbitrator pool from the NASD.

The NASD Code is silent regarding the standards that form the basis for its decisions about whom to include or to exclude from its arbitrator pool. Classification of arbitrators in the pool is important because this area

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[51] *See* McConnell v. Howard Univ., 818 F.2d 58, 68 n.12 (D.C. Cir. 1987); MACNEIL, *supra* note 10, §§ 28.2.5.2, 28:36 & n.106.

[52] *See* NASD CODE OF ARBITRATION PROCEDURE Rules 10102–10104 (National Ass'n of Sec. Dealers, Inc. 1997) (amended 1998).

[53] *See id.* Rule 10308 (amended 1998).

of securities industry control could reasonably be perceived by investors as an avenue to stack the entire NASD arbitrator roster in favor of the securities industry. This could undermine the effectiveness of the newly enacted arbitrator selection rules in eliminating investor perceived bias in favor of the securities industry in the NASD arbitrator selection process.

The balance of this Part will be used to evaluate the arbitrator selection rules in effect prior to November 17, 1998, beginning with the arbitrator classification rules.

A. *Arbitrator Classification Before November 17, 1998*

Prior to November 17, 1998, the rules distinguishing public and securities industry arbitrators in the NASD pool of arbitrators gave rise to a seemingly meaningless distinction under the NASD Code. Furthermore, these classification rules were not effective in avoiding even the appearance of impropriety; arbitrators could be misclassified as public arbitrators in the pool[54] because the rules were based on arbitrary assumptions that caused the classification scheme to be both under-inclusive and over-inclusive, ambiguous, and very difficult to enforce. Accordingly, public arbitrators selected by the Director of Arbitration from the pool could be viewed as biased from the moment they were chosen. In a September 10, 1987 letter to the Securities Industry Conference on Arbitration (SICA), the Commission stated that "the inclusion in the pool of public arbitrators of persons with clear affiliations with the securities industry is a source of great concern."[55] In response, the NASD, with the Commission's approval, proposed and implemented in 1989 NASD Rule 10308. However, the NASD's attempt to distinguish between public and industry arbitrators in NASD Rule 10308(c) was "somewhat arbitrary"[56] and ineffective in eliminating from the public arbitrator pool those persons with clear affiliations with the securities industry. In addition, it did not eradicate, as asserted by the Commission in 1989 when NASD Rule 10308 was initially

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[54] In an inspection of the NASD Arbitration Department, the Commission noted several instances in which it believed that arbitrators may have been misclassified as public arbitrators. *See* ARBITRATION POLICY TASK FORCE, *supra* note 1, at 97.

[55] Order Approving Proposed Rule Changes by the New York Stock Exchange, Inc., National Association of Securities Dealers, Inc., and the American Stock Exchange, Inc. Relating to the Arbitration Process and the Use of Predispute Arbitration Clauses, Exchange Act Release No. 34-26,805, 54 Fed. Reg. 21,144, 21,146 (1989).

[56] ARBITRATION POLICY TASK FORCE, *supra* note 1, at 96.

proposed,[57] investors' doubts about the impartiality of the public arbitrator pool.[58]

NASD Rule 10308(c) used arbitrary time designations to determine whether an individual was biased in favor of the securities industry and therefore should be classified as a securities industry rather than a public arbitrator. Sections (c)(1) and (2) of NASD Rule 10308 arbitrarily assumed that individuals formerly associated with brokers or dealers ceased to be biased in favor of the securities industry three years after being so associated. For example, a person formerly associated with a broker or dealer would be classified as a public arbitrator three years after ceasing to be associated with the broker or dealer, if she was working outside of the securities industry and was not retired from the securities industry. This meant that during the three years immediately after ceasing to be associated with a broker or dealer, she would be classified as a securities industry arbitrator; beginning the fourth year after she had ceased to be employed by the broker or dealer, she would be classified as a public arbitrator. However, if the same person were to become associated again with a broker or dealer five years after being so associated, she would again be classified as a securities industry arbitrator. NASD Rule 10308(c) arbitrarily assumed that bias in favor of the securities industry immediately reappeared the moment an individual again became associated with a broker or dealer.

NASD Rule 10308(c) also used arbitrary time designations when classifying professionals (attorneys, accountants, and so on) as either public or securities industry arbitrators. Professionals were perceived to be biased only if they devoted twenty percent or more of their professional work effort to securities industry clients within the last two years. For example, if, within the last two years, an attorney devoted 19.99% of his professional work effort to representing clients in the securities industry, he would not be perceived as biased in favor of the securities industry and would be classified as a public arbitrator. However, if this same attorney just one year later began to devote twenty percent of his professional work effort to representing securities industry clients, he would then be perceived as biased in favor of the securities industry and classified as an industry arbitrator in the NASD arbitrator pool. Neither the NASD Code nor related commentary provide a basis for the assumptions underlying these arbitrary time designations. Essentially under NASD Rule 10308(c), the same person

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[57] *See* Order Approving Proposed Rule Changes, 54 Fed. Reg. at 21,147.

[58] *See* ARBITRATION POLICY TASK FORCE, *supra* note 1, at 94.

could be classified as a securities industry arbitrator one year and as a public arbitrator the next year, regardless of actual or perceived bias.

Under NASD Rule 10308(c), the NASD arbitrarily determined that professionals and persons effecting transactions in commodities required less time than persons associated with brokers or dealers to eliminate any biases they might harbor in favor of the securities industry.[59] An attorney, accountant, or other professional was deemed to be no longer biased in favor of the securities industry after just two years. However, a person formerly associated with a broker or dealer required three years away from the securities industry to be no longer biased in favor of the securities industry. Individuals registered under the Commodity Exchange Act (CEA), members of registered futures association or any commodities exchange, or individuals associated with such persons were, apparently, even less prone to pro-securities industry bias than professionals and other persons associated with brokers or dealers. These individuals seemingly ceased to be biased in favor of the securities industry the moment they discontinued registration under the CEA, or membership with a registered futures association or commodities exchange. Subsection (c)(5) of NASD Rule 10308 allowed such individuals to be classified as public arbitrators in the NASD arbitrator pool the moment they ceased to be registered or were no longer members of registered futures associations or commodities exchanges.[60] This meant that a person who had spent his entire career in the securities industry could be classified as a public arbitrator in the NASD arbitrator pool.

NASD Rule 10308(c) was ambiguous and under-inclusive because, in failing to define the term "retire" (a key term used in its definition of a securities industry arbitrator), it allowed individuals reasonably perceived as biased in favor of the securities industry to be classified as public arbitrators.[61] It was unclear whether a person had to meet certain age or length of service requirements to retire from the industry or merely had to leave the industry and not engage in any other work. If the term retire was defined as requiring certain age or length of service requirements, it allowed individuals to be classified as public arbitrators who might have spent the majority of their careers working in the securities industry. This again may have resulted in at least the perception that individuals affiliated

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[59] *See* NASD CODE OF ARBITRATION PROCEDURE Rule 10308(c)(1)-(3) (National Ass'n of Sec. Dealers, Inc. 1997) (amended 1998).

[60] *See id.* Rule 10308(c)(4) (amended 1998).

[61] *See id.* Rule 10308(c)(3) (amended 1998).

with or biased in favor of the securities industry were included in the NASD's pool of public arbitrators. For example, an individual would be classified as a public arbitrator who worked twenty years in the securities industry, did not retire from the securities industry, and subsequently worked outside the securities industry for just over three years. An individual with this type of background could be perceived as, and could well be, biased in favor of the securities industry. Accordingly, such individuals should not be included in the NASD's pool of public arbitrators.

NASD Rule 10308(c) was also over-inclusive because, in failing to define the term "retire," it likely excluded individuals reasonably perceived as not biased in favor of the securities industry from the NASD's public arbitrator pool. An individual was automatically and forever classified as a securities industry arbitrator if she had retired from the securities industry. Although it seems logical to assume that if an individual retired from the securities industry that she would, at least, be perceived as biased in favor of the securities industry, this is not always the case. Assuming that the term "retire" means meeting certain age or length of service requirements, this section would exclude from the public arbitrator pool anyone who had retired from the securities industry and was subsequently employed, for just over three years, representing the interests of public investors, e.g., working for the Commission. It would also exclude individuals retired from the securities industry but employed in the securities industry for less than three years. If time is a material factor in determining the existence of pro-securities industry bias, it would seem that a person only employed in the securities industry for less than three years, even though retired from the securities industry, would not be as biased in favor of the securities industry as someone whose entire career consisted of working in the securities industry. For example, a person could have worked for a government agency clearly dedicated to protecting the interests of public investors for most of his career, retired from this government agency, then worked for a securities brokerage firm for one year and, after one year, retired from the securities brokerage firm.[62] NASD Rule 10308(c) would clearly prohibit this individual from serving as a public arbitrator; however, given his background, investors might reasonably perceive that this individual should be classified as a public arbitrator rather than as a securities industry arbitrator. These types of arbitrary results undermined the credibility of the pool from which public arbitrators were selected and

[62] Indeed, the author, being a former senior counsel at the Commission, personally knows someone who did just this.

further fueled the perception by investors that the arbitrator panels were biased in favor of the securities industry.

Section (c) of NASD Rule 10308 was under-inclusive because it failed to classify certain members of the securities industry as securities industry arbitrators. Investment advisers not associated with brokers or dealers, municipal securities dealers, government securities brokers, or government securities dealers, were classified as public arbitrators.[63] The NASD determined that these types of investment advisers "[were] more akin to investors and should be placed in the public arbitrator pool."[64] This meant that investment advisers associated with other financial firms such as investment companies and insurance companies would be classified as public arbitrators in the NASD's pool of arbitrators. The NASD's classification of investment advisers as public arbitrators was inconsistent with the Uniform Code of Arbitration (Uniform Code), which bars investment advisers from serving as public arbitrators.[65] Investment advisers, like other members of the securities industry, are regulated under federal and state securities laws. Specifically, investment advisers are regulated under the Investment Advisers Act of 1940 (Advisers Act).[66] Under the Advisers Act, an investment adviser is defined as "any person, who for compensation, engages in the business of advising others . . . as to the value of securities or as to the advisability of investing in, purchasing, or selling securities . . . ."[67] The Advisers Act is, among other things, designed to protect the public from fraud or misrepresentation by investment advisers[68] and requires certain investment advisers to register

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[63] *See* NASD CODE OF ARBITRATION PROCEDURE Rule 10308(c)(1) (National Ass'n of Sec. Dealers, Inc. 1997) (amended 1998).

[64] Order Approving Proposed Rule Changes by the New York Stock Exchange, Inc., National Association of Securities Dealers, Inc., and the American Stock Exchange, Inc. Relating to the Arbitration Process and the Use of Predispute Arbitration Clauses, Exchange Act Release No. 34-26,805, 54 Fed. Reg. 21,144, 21,146 (1989).

[65] *See id.* It was also inconsistent with the Arbitration Code of the New York Stock Exchange, Inc. (NYSE), which followed the Uniform Code in classifying registered investment advisers as securities industry arbitrators. *See* New York Stock Exchange, Inc., *Constitution of the New York Stock Exchange, Inc.*, art. IX, R. 607 (visited Aug. 23, 1999) <http://www.nyse.com/public/invprot//5d/05d1/05d1c/5d1c09fm.htm>.

[66] *See* Investment Advisers Act of 1940 § 201, 15 U.S.C. § 80b-1 (1994).

[67] Investment Advisers Act of 1940 § 202, 15 U.S.C. § 80b-2(a)(11) (1994).

[68] For example, the Advisers Act requires advisers to disclose all potential conflicts of interest with any recommendations they make to those they advise. *See*

with the Commission.[69] In other words, investment advisers are regulated essentially in the same manner and for the same purpose (the protection of investors) as brokers or dealers. Accordingly, there seems to be no reasonable basis for allowing investment advisers to serve as public arbitrators under the NASD Code.

Professionals, such as attorneys and accountants, in the NASD pool of public arbitrators were even more likely to be perceived as biased in favor of the securities industry because section (c)(4) of NASD Rule 10308 only applied to the individual and not to his firm. This meant that a professional would be classified as a public arbitrator, but his individual firm would be free to represent securities industry clients with impunity. For example, an individual attorney working at a firm who had not represented securities industry clients within the last two years could be classified as a public arbitrator while his firm was actively representing securities industry clients, i.e., devoting more than twenty percent of its work effort to securities industry clients. However, exclusion from the public arbitrator pool of attorneys, accountants, or professionals whose partners or firms regularly provide services to the securities industry would aid in eliminating the perception of NASD staff bias and prejudgment because the economic ties between partners gives rise to an appearance of bias.[70]

Moreover, it is questionable whether work effort alone should be the primary factor in determining whether to classify an individual as a public or securities industry arbitrator. An attorney, accountant, or other professional may devote less than twenty percent of his or her professional

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Investment Advisers Act of 1940 § 203, 15 U.S.C. § 80b-3(c)(1) (1994). A potential conflict of interest might exist where the adviser had a position in a security she was recommending.

[69] Generally, investment advisers with assets under management of not less than $25,000,000, or who are advisers to registered investment companies, must register with the Commission. *See id.* § 80b-3. Investment advisers with assets under management of less than $25,000,000 may be required to register in the state in which they maintain their principal office and place of business. *See, e.g.*, N.Y. GEN. BUS. LAW § 359-eee (McKinney 1998).

[70] *See* John R. Allison, *A Process Value Analysis of Decision-Maker Bias: The Case of Economic Conflicts of Interest*, 32 AM. BUS. L.J. 481, 513 (1995). "[T]he law traditionally has treated economic interests as the worst form of biasing influence, particularly in the case of judges." *Id.* at 514 (citing John Leubsdorf, *Theories of Judging and Judge Disqualification*, 62 N.Y.U. L. REV. 237, 245 (1987)). The NYSE Code of Arbitration Procedure recognizes challenges for cause of lawyers and other professionals whose partners represent the securities industry. *See* Order Approving Proposed Rule Changes, 54 Fed. Reg. at 21,144.

work effort to securities industry clients, but this work effort could represent more than twenty percent of his or her income. In addition, income from securities industry clients could represent the professional's greatest source of consistent income. Some combination of work effort and income derived from representing securities industry clients might be a better indicator of the presence of bias in favor of the securities industry when determining whether to classify a professional as either a public or securities industry arbitrator.

Subsection (d) of NASD Rule 10308 seemingly fueled investor perception that the NASD arbitrator selection process was biased in favor of the securities industry because it allowed spouses and other household members of persons associated with the securities industry to serve as securities industry arbitrators. It is likely that spouses and household members of persons associated with the securities industry would be perceived as biased in favor of securities industry members even if only appointed as securities industry arbitrators. Generally, it is appropriately perceived that such persons' economic interests are closely tied to members of the securities industry. Although the NASD Code requires "all arbitrators, both public and industry, . . . to be neutral, and [to] . . . have no affiliation or bias towards either party,"[71] prohibiting such individuals from serving as arbitrators (whether securities industry or public) would better support this underlying principle. The Uniform Code and the AAA Code[72] prohibit such individuals from serving as public or securities industry arbitrators.

The distinction between public and securities industry arbitrators was also difficult to enforce because an arbitrator's status could change from year to year. Accordingly, it might be "difficult for the NASD to maintain accurate records of an arbitrator's classification."[73]

The author concedes that promulgating arbitrator classification rules that eliminate ambiguity, under-inclusiveness, and over-inclusiveness is extremely difficult. A comparison between the rules classifying public and securities industry arbitrators under the AAA Code and NASD Rule 10308 reveals the difficulty of formulating rules which eliminate real or even apparent bias. However, investors and their counsel seem to perceive that the AAA arbitrator selection process is fair and unbiased,[74] despite the fact

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[71] Order Approving Proposed Rule Changes, 54 Fed. Reg. at 21,145–46.

[72] *See* SEC. ARBITRATION Rule 13 (American Arbitration Ass'n 1993).

[73] ARBITRATION POLICY TASK FORCE, *supra* note 1, at 97.

[74] *See* PIABA, *supra* note 1, at 11–23.

that its attempt to distinguish between public and securities industry arbitrators is, like the NASD Code, arbitrary and ambiguous.[75] In fact, the AAA's classification rules are, like the NASD Code, based on the Uniform Code.

Rule 13 of the AAA Code (AAA Rule 13) classifies arbitrators as either affiliated arbitrators (securities industry arbitrators) or not affiliated arbitrators (public arbitrators). Securities industry arbitrators are defined as persons out of the securities industry for more than ten years. The phrase "out of the industry" is not specifically defined under AAA Rule 13. AAA Rule 13 defines a public arbitrator as a person who has or has had direct involvement in or a relationship with the securities brokerage industry for a minimum of three years if currently employed in that industry, or for a minimum of five years if no longer employed.[76] The phrase "involvement in or relationship with" is defined as "(a) employment at a brokerage firm in a professional capacity, whether employed in sales, management, support or trading; or (b) employment as counsel, accountant or other professional who devotes a majority of his or her efforts to brokerage or brokerage-related matters."[77]

In contrast to NASD Rule 10308, the AAA has determined that if a person has had no involvement or relationship with the securities industry for more than ten years, he is qualified to be a neutral or public arbitrator and would not be perceived by the parties as biased in favor of the securities industry. Accordingly, securities professionals who have not been employed in the industry, or have been retired for more than ten years, would be classified as public arbitrators in the AAA arbitrator pool. The arbitrary time restriction of ten years allows persons who have spent their entire careers in the securities industry to be included as public arbitrators in the AAA arbitrator pool. However, such individuals could not be classified as public arbitrators in the NASD arbitrator pool. Like the NASD Code, the AAA Code does not provide a reason for its determination that ten years is sufficient time for former industry members to eradicate any real or apparent bias in favor of the securities industry.

The AAA Code is less precise in its definition of the securities industry than NASD Rule 10308. AAA Rule 13 uses the terms "brokerage," "securities brokerage," and "brokerage-related matters," but fails to define

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[75] It is notable that the NASD Task Force Report did not include a recommendation to adopt the definitions of public and securities industry arbitrators under the AAA Code. *See* ARBITRATION POLICY TASK FORCE, *supra* note 1, at 96.

[76] *See* SEC. ARBITRATION Rule 13 (American Arbitration Ass'n 1993).

[77] *Id.*

these terms. Consequently, it is unclear who is included in the AAA Code's definition of securities industry. Based on a reading of the entire text of AAA Rule 13, it appears that these terms refer to individuals employed by or associated with such groups as brokers or dealers, municipal securities dealers, government securities dealers, and their firms. It is not clear, however, whether terms used to describe the securities industry in AAA Rule 13 include, for example, investment advisers or members and associated persons of registered futures associations. In contrast, NASD Rule 10308 expressly stated those included in its definition of securities industry as follows: persons associated with brokers or dealers, municipal securities dealers, government securities brokers or government securities dealers, and persons registered under the CEA or members and associated persons of registered futures associations; investment advisers were specifically excluded.[78] The meaning of the phrase "employment in a professional capacity" in AAA Rule 13 is also unclear. It cannot be determined from the text of AAA Rule 13 whether this phrase includes only those employees who are required to register under the Exchange Act,[79] or others who may be employed in a professional capacity in the securities industry, e.g., those employees required to register under the CEA or the Investment Advisers Act.[80]

However, AAA Rule 13 is more effective in eliminating economic ties that create an appearance of bias in its public arbitrator pool. If a

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[78] The NASD has determined that investment advisers are akin to investors and therefore would be classified as public arbitrators in its arbitrator pool. *See* Order Approving Proposed Rule Changes by the New York Stock Exchange, Inc., National Association of Securities Dealers, Inc., and the American Stock Exchange, Inc. Relating to the Arbitration Process and the Use of Predispute Arbitration Clauses, Exchange Act Release No. 34-26,805, 54 Fed. Reg. 21,144, 21,146 (1989).

[79] Section 15 of the Exchange Act and Rules 15b1-1 and 15b7-1 thereunder require brokers or dealers and those persons associated with brokers or dealers to register with the Commission by filing an application for registration with the Central Registration Depository operated by the NASD. *See* Securities Exchange Act of 1934 § 15, 15 U.S.C. § 78o (1994 & Supp. III 1997); Application for Registration of Brokers or Dealers, 17 C.F.R. § 240.15b1-1 (1997); Compliance with Qualification Requirements of Self-Regulatory Organizations, § 240.15b7-1 (1997). Associated persons include any partner, officer, director, branch manager, or employee, but excludes those whose functions are solely clerical or ministerial, i.e., those who are not engaged in the purchase and sale of securities. *See* Securities Exchange Act of 1934 § 15(a)(18), 15 U.S.C. § 78c(a)(18) (1994).

[80] Changes made to the AAA Code included an effort to make these rules applicable to commodities matters. *See* AMERICAN ARBITRATION ASS'N, REPORT OF THE AMERICAN ARBITRATION ASSOCIATION SECURITIES ARBITRATION TASK FORCE 1 (1993).

professional does not qualify as a securities industry arbitrator under AAA Rule 13 (employment as counsel, accountant, or other professional who devotes a majority of her efforts to the securities industry) but her firm derives significant income from the securities industry, she is excluded from both public and securities industry arbitrator pools of the AAA. In contrast, NASD Rule 10308 only targeted the individual at the firm; it did not reach the firm itself and may have resulted in an individual being classified as a public arbitrator while being employed at a firm that devoted most of its work effort to, and derived the greatest consistent source of income from, the securities industry. AAA Rule 13 also classifies professionals as public or securities industry arbitrators based on the amount of income generated from work performed for or in the securities industry *and* the amount of work effort devoted to securities industry clients. AAA Rule 13 prohibits a professional from being classified as a public arbitrator if the "majority of his or her efforts" is devoted to the securities industry. Although this phrase is not specifically defined in the text of AAA Rule 13, according to AAA, "[a] 'majority' . . . would be administratively defined as more than fifty percent."[81] Although NASD Rule 10308 was more precise because it expressly stated that professionals could be classified only as public arbitrators if they devoted less than twenty percent of their work effort to securities industry clients, its standard was considerably lower than the AAA Code fifty percent rule. This is significant because economic ties have been recognized as a particularly potent form of biasing influence.[82] In addition, under AAA Rule 13, individuals whose family members "derive significant income" from the securities industry are prohibited from serving as either public arbitrators or securities industry arbitrators.[83] In contrast, such individuals were allowed to serve as securities industry arbitrators under NASD Rule 10308. By targeting both the individual and his firm as well as family members of persons employed in the securities industry, AAA Rule 13 more effectively addresses the issue of the appearance of bias in favor of the securities industry in its pool of public arbitrators. It attempts to eliminate economic interests (traditionally treated as one of the strongest

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[81] *Id.* at 5.

[82] *See* Allison, *supra* note 70, at 513–14; *see also* Order Approving Proposed Rule Changes, 54 Fed. Reg. at 21,146.

[83] *See* AMERICAN ARBITRATION ASS'N, *supra* note 80, at 5.

forms of biasing influence)[84] as a basis for the perception of bias in favor of the securities industry from its arbitrator pool.

Unlike NASD Rule 10308, AAA Rule 13 does not make classification distinctions based on time between members of the securities industry and attorneys, accountants, and other professionals representing securities industry clients. These individuals are subject to the same time restrictions with respect to their direct involvement in or relationship with the securities brokerage industry—a minimum of three years or, if previously employed at, or not currently representing, a securities brokerage firm, a minimum of five years.[85] In contrast, NASD Rule 10308 presumed that a shorter period of time (one year) was required for professionals to eradicate any bias, apparent or otherwise, in favor of the securities industry. Accordingly, professionals could be classified as public arbitrators after only one year, while members of the securities industry required three years. It is reasonable for investors to perceive that both members of the securities industry and those representing securities industry clients would be susceptible to the same influences when determining whether bias in favor of the securities industry has ceased; therefore, different time restrictions probably are not warranted. Given the text of AAA Rule 13, the AAA has apparently also determined that this is a reasonable assumption.

In summary, even though the AAA arbitrator selection process is perceived by investors as fair and unbiased, this perception cannot be based on the clarity and conciseness of its arbitrator classification rules. When compared to the arbitrator classification rules under NASD Rule 10308, AAA Rule 13 contains equally arbitrary assumptions and ambiguous key terms. It seems that when arbitrators are admitted to a pool of arbitrators selected and classified by a securities industry association such as the NASD, individuals admitted to such an entity's arbitrator pool are perceived to be biased in favor of the securities industry association no matter how the classification rules are crafted. This may mean that the NASD's continuing efforts to write and implement rules ensuring the impartiality of individuals admitted to its arbitrator pool may be a futile endeavor. Securities industry-composed and industry-administered

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[84] *See* Allison, *supra* note 70, at 514; *see also* Order Approving Proposed Rule Changes, 54 Fed. Reg. at 21,146.

[85] In this instance, AAA Rule 13 seemingly focuses more on whether an individual is qualified to serve as an industry arbitrator rather than what is required to eliminate an appearance of bias in favor of the securities industry. However, as previously noted, if the individual has been out of the industry for more than ten years, she is classified as a public arbitrator.

arbitrator pools may forever be perceived by investors as consisting of arbitrators whose impartiality is questionable.

1. *Investor Perception of Pro-Securities Industry Bias*

Arbitrator classification rules under NASD Rule 10308 seemingly fueled public customer perception that the NASD pool of arbitrators (whether classified as public or industry) was biased in favor of, and possibly dominated by, the securities industry. Recommendations made by the NASD Task Force did not directly address this issue. Instead, its recommendations emphasized quality, rather than meaningful classification rules. In the author's opinion, this seems the only reasonable course of action when the securities industry is making judgments as to the impartiality of arbitrators serving in its pool of arbitrators.

Specifically, the NASD Task Force recommended that the NASD retain its existing rules defining public and securities industry arbitrators, but use three categories of arbitrators instead of the two categories of arbitrators (securities industry and public) used in NASD Rule 10308. The first category would consist of public arbitrators qualified to be panel chairs.[86] In this category, the public arbitrator must "demonstrate a strong command of NASD arbitration procedure and general arbitration techniques, as well as familiarity with . . . industry practices and substantive law."[87] The second category would also consist of public arbitrators, but without panel chair qualifications.[88] The third category would consist of securities industry arbitrators.[89] However, these three categories were defined using the existing classification rules under NASD Rule 10308. As a result, the categories would be just as "arbitrary and difficult to enforce."[90]

Recognizing the fact that any attempt to distinguish more clearly between public and securities industry arbitrators would possibly require additional "arbitrary assumptions," the NASD Task Force instead focused on quality, i.e., "recruiting arbitrators who are qualified and likely to be acceptable to all parties."[91] The NASD Task Force further contended that

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[86] *See* ARBITRATION POLICY TASK FORCE, *supra* note 1, at 95.

[87] *Id.* at 111.

[88] *See id.* at 95.

[89] *See id.*

[90] *Id.* at 96.

[91] *Id.* at 97.

"[r]emoving some of the definitional barriers"[92] would allow the NASD to focus its recruiting efforts on quality "regardless of the particular details of [the arbitrators'] backgrounds . . . ."[93] While quality is essential to a fair and impartial arbitrator selection process, assuring the independence of arbitrators in the context of arbitrator classification rules, i.e., that arbitrators are impartial and not dominated by the securities industry, is equally important. As noted in the GAO Report, "the fairness of any arbitration proceeding depends largely on the *independence and capability* of the arbitrators."[94]

In conclusion, the arbitrator classification rules of NASD Rule 10308 were fatally flawed because they were based on arbitrary assumptions and certain key terms were either ambiguous or undefined. The author concedes that arbitrary assumptions and ambiguity are probably unavoidable when attempting to classify individuals as either public or securities industry arbitrators. However, the author suggests that investor perception of pro-securities industry bias in the arbitrator classification process could be avoided if the arbitrator classification process were removed from a securities industry arbitral forum, i.e., that an organization other than the NASD should be responsible for the composition and classification of the arbitrator pool used in securities arbitration proceedings between investors and the securities industry. Under NASD Rule 10308, the distinction between public and securities industry arbitrators was critical because a single entity, the NASD, established the qualifications for arbitrators deciding disputes between investors and its members. One of the basic principles in qualifying arbitrators is that no single entity should establish qualifications for all arbitrators in all settings.[95] Accordingly, it is likely that distinguishing between public and securities industry arbitrators is not the determining factor in the perceived fairness of the arbitrator selection process under the NASD Code. The determining factor is most likely that the entity establishing the rules for qualifying individuals to be admitted to the pool of arbitrators from which panels are appointed to resolve disputes between investors and members of the securities industry is not independent of the securities industry itself.

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[92] *Id.*

[93] *Id.*

[94] GENERAL ACCOUNTING OFFICE, *supra* note 1, at 60 (emphasis added).

[95] *See* SPIDR COMM'N ON QUALIFICATIONS, SOCIETY OF PROF'LS IN DISPUTE RESOLUTION, ENSURING COMPETENCE AND QUALITY IN DISPUTE RESOLUTION PRACTICE 1 (1995).

B. *Arbitrator Appointment Process Before November 17, 1998*[96]

Prior to November 17, 1998, the process used by the Director of Arbitration to appoint arbitrators to serve on NASD arbitration panels was reasonably perceived by investors to be structurally linked to, and dominated by, the securities industry.[97] The selection of arbitrators to serve on the panel, and frequently the chairperson of the panel, were determined almost exclusively by the Director of Arbitration.[98] Accordingly, the Director of Arbitration's "selections [had] a significant impact on the composition of the panel."[99] The NASD Code provided minimal guidance to the Director of Arbitration in selecting arbitrators to serve on the panel, requiring only that the individual selected be "knowledgeable" about the securities industry. The NASD Task Force determined that the "NASD arbitration staff attempt[ed] to select panel members who [were] well suited to the nature of the case they [would] hear."[100] As a result, the Director of Arbitration had enormous discretionary power at the onset of the proceedings because she could appoint arbitrators basically without any constraints.[101] Parties could participate in the arbitrator selection process only by exercising a single peremptory challenge, after which the Director of Arbitration selected a replacement. Otherwise, participating in the selection of a single arbitrator or in determining the final composition of the panel could be accomplished only by challenging for cause.[102] Even this participation was limited from the parties' perspective because the Director

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[96] All references to NASD Rule 10308 in this subpart refer to NASD Rule 10308 in effect prior to November 17, 1998.

[97] As previously noted, this is not the case in the arbitration of large and complex cases under NASD Rule 10334. *See* NASD CODE OF ARBITRATION PROCEDURE Rule 10334 (National Ass'n of Sec. Dealers, Inc. 1997) (amended 1998).

[98] *See id.* Rules 10308, 10309 (amended 1998).

[99] ARBITRATION POLICY TASK FORCE, *supra* note 1, at 93.

[100] *Id.*

[101] The GAO determined that arbitrators were selected from the pool of public and securities industry arbitrators based on availability, the appearance of no conflict of interest, and experience in products or issues similar to those in the particular dispute. *See* GENERAL ACCOUNTING OFFICE, *supra* note 1, at 56.

[102] *See* NASD CODE OF ARBITRATION PROCEDURE Rule 10311 (National Ass'n of Sec. Dealers, Inc. 1997) (amended 1998).

of Arbitration also decided challenges for cause until the commencement of the hearing.[103]

Structural bias in the arbitrator appointment process under NASD Rule 10308 was heightened by the fact that the parties received a slate of only three names (two public arbitrators, one of whom would be the chairperson, and one securities industry arbitrator) for a three person panel and only one name for a one person panel upon which to exercise a single peremptory challenge and challenges for cause; however, successfully exercising a challenge for cause was difficult because the criteria were not easily met.[104] The NASD Task Force determined that successfully exercising challenges for cause was particularly difficult for pro se parties because they might not have access to the type of information required to successfully challenge an arbitrator for cause.[105] Even the private securities

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[103] *See id.* 10311, 10313 (amended 1998). "Parties in arbitration could move for recusal of an arbitrator. However, as in civil litigation, most parties are reluctant, for tactical reasons, to do so—namely, that the arbitrator could deny the motion and then be the decision-maker in the matter." ARBITRATION POLICY TASK FORCE, *supra* note 1, at 93 n.129.

[104] Examples of circumstances in which a challenge for cause would be granted included the following:

> 1. *Opinion and bias*: The arbitrator has an unqualified opinion or belief as to the subject of an action for which he or she is an arbitrator, or the arbitrator has a personal bias toward a party.
> 2. *Business or personal relationships*: The arbitrator is related by blood or marriage to any of the parties, attorneys, or witnesses in the arbitration, or the arbitrator is in some way related to the party by means of employment, a debtor or creditor relationship, or the arbitrator is a business partner, a surety, or guarantor of the obligations of any party, or a bondholder or shareholder of any corporate party.
> 3. *Previous or current involvement*: The arbitrator is an adverse party in any action to a party, attorney, or witness in the subject arbitration, or has been accused by such party in another action instituted or resolved within the last five years, or the arbitrator and any party, or the attorney for any party, have been in the relation of attorney and client within five years of the filing of the subject arbitration.
> 4. *Financial interests*: The arbitrator knows that he or she has, individually or as a fiduciary, or his or her spouse or minor child residing in his or her household has a financial interest in the subject matter in controversy or in a party to the arbitration proceeding, or any other interests that could be substantially affected by the outcome of the arbitration proceedings.

ROBBINS, *supra* note 43, § 10.06, at 10-13 to 10-14.

[105] *See* ARBITRATION POLICY TASK FORCE, *supra* note 1, at 94.

bar found this process contentious because it lead to sharp criticism and frequent exchanges of correspondence with counsel for both sides.[106]

To address the issue of structural bias reflected in the fact that arbitrators in the NASD arbitral forum were chosen primarily by the securities industry, the NASD Task Force recommended that the NASD adopt a variant of the AAA's list selection process of appointing arbitrators to serve on arbitration panels.[107] Apparently, investors and their attorneys perceive the AAA arbitrator selection method to be fair and unbiased, allowing for equal participation by the parties.[108]

The AAA Code uses a list selection method to appoint arbitrators to serve on panels in arbitration proceedings between investors and members of the securities industry.[109] Under Rule 14 of the AAA Code (AAA Rule 14), two lists of names and biographical information of persons chosen from the AAA's National Panel of Securities Arbitrators are sent simultaneously to each party to the dispute immediately after the filing of the demand for arbitration. The first list, from which one arbitrator is appointed, contains names of securities industry arbitrators.[110] The second list, from which two arbitrators are appointed, contains names of arbitrators not affiliated with the securities industry or public arbitrators.[111] Each party has twenty days from the transmittal date in which to strike any names objected to, number the remaining names in order of preference, and return the list to the AAA. If a party does not return the list within the time specified, all persons on the list are deemed acceptable to that party.[112]

The AAA appoints the arbitrators who will serve from persons who have been approved on both lists and in accordance with the designated order of mutual preference indicated by the parties. If appointments cannot be made from the submitted lists, the AAA uses an abbreviated list method. Under this method, parties are given a final, prescreened list of proposed

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[106] *See* PIABA, *supra* note 1, at 4–5.

[107] *See* ARBITRATION POLICY TASK FORCE, *supra* note 1, at 94.

[108] "To improve the public's perception of fairness, SEC has urged broker-dealer firms to allow investors the option of using AAA as an arbitration forum." GENERAL ACCOUNTING OFFICE, *supra* note 1, at 60; *see also* PIABA, *supra* note 1, at 10.

[109] If the parties have not appointed an arbitrator and have not provided any other method of appointment, the arbitrator is appointed utilizing the list selection method. *See* SEC. ARBITRATION Rule 14 (American Arbitration Ass'n 1993).

[110] *See id.* The AAA uses the phrase "arbitrators affiliated with the securities industry" when referring to securities industry arbitrators. *Id.*

[111] *See id.* AAA Rule 14 does not state how many names must appear on each list.

[112] *See id.*

arbitrators, consisting of a limited number of names (as an administrative practice, three names would be proposed for each vacancy).[113] Each separately appearing party may strike, on a peremptory basis, one name for each arbitrator to be appointed; the list must be returned to the AAA within ten days from the date of transmittal. The AAA then makes the appointments from names remaining on the list. This abbreviated list method is only used by the AAA after the list selection method has failed to seat a complete panel.

In contrast, the arbitrator appointment process under NASD Rule 10308 did not provide for meaningful participation by the parties and, appropriately, fueled investor perception of a pro-securities industry bias. Unlike NASD Rule 10308, AAA Rule 14 allows the parties meaningful participation in the arbitrator appointment process because each party can strike any objectionable names on the lists and is not confined to the exercise of only one peremptory challenge plus challenges for cause.[114] In comparison, .for a three person panel under NASD Rule 10308, the Director of Arbitration only provided the parties with a slate of three names upon which the parties could exercise only one peremptory challenge plus challenges for cause. If a panel was not completed, the Director of Arbitration was only required to submit one name per vacancy to the parties,[115] instead of the three names per vacancy required under AAA Rule 14 when its list selection method failed to seat a complete panel.

It is interesting that investors and their counsel perceive the AAA arbitrator selection process to be fair and unbiased even in small claims cases, in which the AAA does not use the list selection process described above. In fact, both permit only limited input by the parties in the selection of arbitrators.[116] Under both the AAA Code and the NASD Code, unless the parties object, all claims less than $25,000 (exclusive of interest and arbitration costs) are heard by a single public arbitrator.[117] Under the AAA

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[113] *See* AMERICAN ARBITRATION ASS'N, *supra* note 80, at 4.

[114] As previously noted, the Director of Arbitration may award additional peremptory challenges if he determines that the "interest of justice would be best served by awarding additional peremptory challenges." NASD CODE OF ARBITRATION PROCEDURE Rule 10311 (National Ass'n of Sec. Dealers, Inc. 1997) (amended 1998).

[115] *See id.* Rules 10309, 10311 (amended 1998).

[116] *See id.* Rule 10302 (amended 1998); *see also* SEC. ARBITRATION Rule 52 (American Arbitration Ass'n 1993).

[117] *See* NASD CODE OF ARBITRATION PROCEDURE Rule 10302 (National Ass'n of Sec. Dealers, Inc. 1997) (amended 1998); SEC. ARBITRATION Rule 18 (American Arbitration Ass'n 1993).

Code, this single public arbitrator is chosen by, first, selecting five proposed public arbitrators drawn from the AAA's National Panel of Securities Arbitrators and submitting this list of names simultaneously to each party.[118] Next, each party may strike two names from the list on a peremptory basis and has unlimited challenges for cause. Then, AAA appoints a single arbitrator from the names remaining on the list.[119] If for any reason the appointment of an arbitrator cannot be made from this list, the AAA may make the appointment from among other members of its National Panel of Securities Arbitrators without the submission of additional lists to the parties. Similarly, under the NASD Code, the Director of Arbitration appoints a single public arbitrator to hear the case. The public arbitrator is appointed in the sole discretion of the Director of Arbitration; the NASD Code requires only that the Director of Arbitration appoint a public arbitrator from the NASD arbitrator pool who is "knowledgeable in the securities industry."[120] Parties participate in this appointment process only by exercising a single peremptory challenge and challenges for cause.[121]

Both the NASD Code and AAA Code leave the selection of arbitrators for small claims essentially within the discretion of their staff. The only notable difference between the two codes is that the AAA Code submits five names for consideration to the parties and allows two peremptory challenges per party, while the NASD Code submits only one name to the parties and allows one peremptory challenge per party; the Director of Arbitration then appoints an arbitrator to decide the case. Both the AAA Code and the NASD Code allow unlimited challenges for cause.[122] Basically, the securities industry, through its industry association, the NASD, exercises unfettered discretion in the appointment of arbitrators in arbitration proceedings involving small claims.

In summary, NASD procedures for appointment of arbitrators to serve on panels failed to "avoid even the appearance of impropriety"[123] and reasonably fueled public customer perception that the arbitrator

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[118] *See* SEC. ARBITRATION Rule 52 (American Arbitration Ass'n 1993).

[119] *See id.*

[120] NASD CODE OF ARBITRATION PROCEDURE Rule 10302(f) (National Ass'n of Sec. Dealers, Inc. 1997) (amended 1998).

[121] *See id.* Rule 10311 (amended 1998).

[122] *See id.*; SEC. ARBITRATION Rule 20 (American Arbitration Ass'n 1993).

[123] ARBITRATION POLICY TASK FORCE, *supra* note 1, at 94.

appointment process, and possibly NASD arbitrators, were biased in favor of the securities industry.

IV. THE CURRENT NASD ARBITRATOR SELECTION PROCESS

Recognizing that the legitimacy of the NASD arbitral forum depended significantly on lessening investor perception that the arbitrator selection process was biased in favor of the securities industry, the NASD amended its rules governing the selection of arbitrators.[124] Effective November 17, 1998, NASD Rule 10308 was amended to "[allow] the parties to play the dominate [sic] role in selecting their arbitrators."[125] According to the NASD and the Commission, the new arbitrator selection rules should effectively address difficulties noted by the NASD Task Force in its review of the NASD arbitrator selection process—the appearance of impropriety because of perceived NASD staff bias and prejudgment and no meaningful participation by the parties.

Specifically, NASD Rule 10308 was amended (amended NASD Rule 10308) to provide for a list selection method for appointing arbitrators to serve on panels; arbitrators are now placed on the lists on a rotating basis.[126] But though amended NASD Rule 10308 no longer allows appointment of arbitrators to panels solely in the discretion of the Director of Arbitration, it does not adequately address the issues raised in the NASD Task Force Report concerning investors' perceptions of bias in favor of the securities industry.[127] Because the NASD failed to implement the list selection method recommended by the NASD Task Force in its entirety, amended NASD Rule 10308 fails to wholly eliminate investor perception of bias in favor of the securities industry in the NASD arbitrator selection process. Amended NASD Rule 10308 continues to allow too much discretion in the NASD arbitrator selection process by the securities industry. Moreover, amended NASD Rule 10308 basically maintains the existing arbitrator classification rules under the NASD Code and also

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[124] *See generally* Order Granting Approval to Proposed Rule Change Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, Exchange Act Release No. 34-40,555, 63 Fed. Reg. 56,670 (1998).

[125] Notice of Filing of Proposed Rule Change Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, Exchange Act Release No. 34-40,261, 63 Fed. Reg. 40,761, 40,765 (1998).

[126] The NASD also proposed conforming changes to Rules 10104, 10309, 10310, 10311, 10312, and 10313. *See id.*

[127] The term "securities industry" includes both securities and commodities.

controls those admitted to the NASD arbitrator pool. As a result, the issue of investor perception that the NASD arbitrator selection process is biased in favor of the securities industry remains unresolved.

The remainder of this Article will analyze factors supporting the author's contention that amended NASD Rule 10308 does not adequately support the NASD's goal of providing an arbitral forum that is fair to all parties, i.e., one in which each party equally participates in the selection of the arbitrators. First, the minimal changes made to the arbitrator classification system will be reviewed. Second, changes to the rules governing the appointment of arbitrators to serve on panels will be analyzed.

A. *Arbitrator Classification Under Amended NASD Rule 10308*

Under amended NASD Rule 10308, arbitrator classification in the NASD arbitrator pool remains ineffective in avoiding even the appearance of impropriety in the arbitrator selection process. This is because the arbitrator classification scheme remains "largely" the same.[128] This means that investor perception of a pro-securities industry bias in the arbitrator selection process continues to be fueled by arbitrator classification rules that could easily result in misclassification of arbitrators in the NASD arbitrator pool. Like prior NASD Rule 10308, arbitrator classification rules under amended NASD Rule 10308 are based on arbitrary assumptions that cause the classification scheme to be under-inclusive, over-inclusive, ambiguous, and very difficult to enforce.

Again, as under prior NASD Rule 10308, arbitrators classified as public arbitrators in the NASD arbitrator pool under amended NASD Rule 10308 could be viewed as biased from the moment they are chosen from the NASD arbitrator pool. However, there are some significant changes in amended NASD Rule 10308 that seemingly exacerbate the difficulties noted in the arbitrator classification scheme under prior NASD Rule 10308. The remainder of this subpart will address these changes and their impact on investor perception of a pro-securities industry bias in the NASD arbitrator selection process.

Amended NASD Rule 10308 continues to use arbitrary time designations to determine whether an individual is biased in favor of the securities industry and therefore should be classified as a securities

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[128] Order Granting Approval to Proposed Rule Change Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, 63 Fed. Reg. at 56,673.

industry[129] arbitrator rather than a public arbitrator. However, amended NASD Rule 10308 now includes individuals employed in the commodities industry within its arbitrary three year rule distinguishing public and securities industry arbitrators. Specifically, amended NASD Rule 10308 now arbitrarily assumes that individuals formerly associated with the securities or commodities industry are perceived by public customers as no longer biased in favor of the securities industry[130] three years after being so associated. Unlike prior NASD Rule 10308, amended NASD Rule 10308 no longer arbitrarily assumes that individuals who engage in commodities transactions cease to be biased in favor of the securities industry the moment they discontinue registration under the CEA or membership with a registered futures association or commodities exchange. Under section (a)(4) of amended NASD Rule 10308:

> The term "non-public arbitrator" [securities industry arbitrator] means a person who is otherwise qualified to serve as an arbitrator and:
>
> (A) *is, or within the past three years* was:
>
> (i) associated with a broker or a dealer (including a government securities broker or dealer or municipal securities dealer);
>
> (ii) registered under the Commodity Exchange Act;
>
> (iii) a member of a commodities exchange or a registered futures association; or
>
> (iv) associated with a person or firm registered under the Commodity Exchange Act;
>
> (B) is retired from engaging in any of the business activities listed in subparagraph (4)(A);
>
> (C) is an attorney, accountant, or other professional who has devoted 20 percent or more of his or her professional work, in the last two years, to clients who are engaged in any of the business activities listed in subparagraph (4)(A); or
>
> (D) is an employee of a bank or other financial institution and effects transactions in securities, including government or municipal securities, and commodities futures or options or supervises or monitors the

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[129] Amended NASD Rule 10308 uses the term "non-public arbitrator" to describe securities industry arbitrators. *See* NASD CODE OF ARBITRATION PROCEDURE Rule 10308(a)(4) (National Ass'n of Sec. Dealers, Inc. 1999); *see also* Order Granting Approval to Proposed Rule Change Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, 63 Fed. Reg. at 56,671.

[130] The term "securities industry" is used to refer to persons effecting transactions in commodities and other securities throughout this Article.

> compliance with the securities and commodities laws of employees who engage in such activities.[131]

Although amended NASD Rule 10308 does away with the unsupported, arbitrary assumption that persons engaged in commodities transactions are no longer biased in favor of the securities industry the moment they cease to engage in such transactions, it elevates another group of securities professionals to this lofty status. Paragraph (a)(4)(D) of amended NASD Rule 10308 specifically excludes employees of banks or other financial institutions who are engaged in securities and commodities transactions and supervisors of such persons from the NASD public arbitrator pool. However, such individuals may be classified as public arbitrators in the NASD arbitrator pool the moment they cease to be employed, to effect securities and commodities transactions, or to supervise persons effecting such transactions. This means that a person who has spent her entire career in the securities industry may be classified as a public arbitrator in the NASD arbitrator pool. In addition, amended NASD Rule 10308 continues to assume that professionals (attorneys, accountants, and such) representing securities industry clients require less time than persons associated with brokers or dealers to eliminate any bias they might harbor in favor of the securities industry; professionals require only two years to eliminate any bias they might harbor in favor of the securities industry, while those employed in the securities industry require three years.

Like its predecessor, amended NASD Rule 10308 fails to provide a basis for the use of arbitrary time designations to determine whether bias in favor of the securities industry no longer exists. As previously noted under prior NASD Rule 10308, the use of such arbitrary time designations in the classification of arbitrators may result in the same person being classified as a securities industry arbitrator one year and as a public arbitrator the next year. Seemingly, this would not alleviate investor concern that the NASD public arbitrator pool includes individuals affiliated with the securities industry. Moreover, such an affiliation could reasonably support investor perception that the NASD arbitrator selection process continues to be biased in favor of the securities industry.

The failure to define the key term "retire" in the definition of securities industry arbitrator in amended NASD Rule 10308 also makes it subject to

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[131] NASD CODE OF ARBITRATION PROCEDURE Rule 10308(a)(4) (National Ass'n of Sec. Dealers, Inc. 1999); *see also* Order Granting Approval to Proposed Rule Change Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, 63 Fed. Reg. at 56,671.

the same difficulties as prior NASD Rule 10308—ambiguity, under-inclusiveness, and over-inclusiveness. Failure to define the term "retire" may both *include* in the NASD public arbitrator pool individuals reasonably perceived as biased in favor of the securities industry and *exclude* from the NASD public arbitrator pool individuals reasonably perceived as not biased in favor of the securities industry. For example, if the term "retire" is assumed to require certain age or length of service requirements, a person who had worked twenty years in the securities industry, did not "retire" from the securities industry, and subsequently worked outside the securities industry for just over three years could be classified as a public arbitrator. On the other hand, a person "retired" from the securities industry could be forever classified as a securities industry arbitrator, even though employed for just over three years in a job representing the interests of investors, e.g., working at the Commission. These types of arbitrary results undermine the credibility of the NASD public arbitrator pool. In addition, under amended NASD Rule 10308, this particular ambiguity now embraces individuals registered under the CEA, members of commodities exchanges or registered futures associations, and associated persons or firms registered under the CEA.[132]

Amended NASD Rule 10308 interjects more ambiguity into the NASD arbitrator classification scheme by failing to define the phrase "a person who is otherwise qualified to serve as an arbitrator" in the text of its definitions of public and securities industry arbitrators.[133] Explanations provided by the NASD in its Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change (Commentary) fail to provide sufficient clarification. According to the Commentary, a qualified securities industry arbitrator "must have the professional securities experience (or the related qualifications) listed in subparagraph (a)(4)" of amended NASD Rule 10308.[134] This means that a person is qualified to be a securities

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[132] *See* NASD CODE OF ARBITRATION PROCEDURE Rule 10308(a)(4)(A)(ii)-(iv) (National Ass'n of Sec. Dealers, Inc. 1999); *see also* Order Granting Approval to Proposed Rule Change Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, 63 Fed. Reg. at 56,671.

[133] *See* NASD CODE OF ARBITRATION PROCEDURE Rules 10308(a)(4)-(a)(5) (National Ass'n of Sec. Dealers, Inc. 1999); *see also* Order Granting Approval to Proposed Rule Change Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, 63 Fed. Reg. at 56,671.

[134] Notice of Filing of Proposed Rule Change Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, Exchange Act Release No. 34-40,261, 63 Fed. Reg. 40,761, 40,767 (1998); *see also* Order Granting Approval to

industry arbitrator if she has worked in the securities industry for at least three years or is retired from the securities industry; is an attorney, accountant, or other professional who represented securities industry clients, within the last two years, more than twenty percent of the time; or is employed at a bank or other financial institution and effects securities transactions or supervises persons who effect securities transactions. Despite this "clarification," it is unclear how the securities industry arbitrator must be "otherwise qualified." As currently written, this qualification, in the context of the definition of securities industry arbitrator, seems, at best, redundant.

In addition, if the NASD is attempting to ensure that those serving as securities industry arbitrators have the requisite experience and knowledge to do so, it does not effectively achieve this objective with respect to bank or other financial institution employees. The moment a person begins to work at a bank or other financial institution and to effect transactions in securities or commodities or supervises such persons, she would be qualified to serve as a securities industry arbitrator. It is difficult to comprehend how such a bank employee is "qualified," i.e., has the requisite securities or commodities experience that the NASD seems to assert is necessary to serve as a securities industry arbitrator. It is also questionable whether three years is sufficient to gain the requisite securities industry experience and knowledge.

More importantly, the phrase "a person who is otherwise qualified to serve as an arbitrator" is even more unclear, if that is possible, when used in the definition of "public arbitrator" in amended NASD Rule 10308. Section (a)(5) of amended NASD Rule 10308 states that:

> (A) The term "public arbitrator" means a person who is otherwise qualified to serve as an arbitrator and is not:
>
> (i) engaged in the conduct or activities described in paragraphs (a)(4)(A) through (D); or
>
> (ii) the spouse or an immediate family member of a person who is engaged in the conduct or activities described in paragraphs (a)(4)(A) through (D).
>
> (B) For the purpose of this rule, the term "immediate family member" means:
>
> (i) a family member who shares a home with a person engaged in the conduct or activities described in paragraphs (a)(4)(A) through (D);

Proposed Rule Change Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, 63 Fed. Reg. at 56,673 n.11.

(ii) a person who receives financial support of more than 50 percent of his or her annual income from a person engaged in the conduct or activities described in paragraphs (a)(4)(A) through (D); or

(iii) a person who is claimed as a dependent for federal income tax purposes by a person engaged in the conduct or activities described in paragraphs (a)(4)(A) through (D).[135]

According to the Commentary, "'[p]ublic arbitrator' generally means a person who is otherwise qualified to serve as an arbitrator and is not engaged in the conduct of, or business activities that indicate an affiliation with, the securities industry or the related industries."[136] This means that a person will not be classified as a public arbitrator in the NASD arbitrator pool if that person:

(a) is currently employed in the securities or commodities industry or a person retired from such business activities;

(b) is a professional who devotes twenty (20) percent or more of his or her time to securities industry clients; or

(c) is an employee of a bank or other financial institution who is engaged in securities activities or in the supervision of such activities.[137]

The definition of the term "public arbitrator" in amended NASD Rule 10308(a)(5) apparently allows persons clearly affiliated with the securities industry to be included in the NASD public arbitrator pool. Based on the definition of the term "public arbitrator" in amended NASD Rule 10308(a)(5) and the explanation in the Commentary, it seems that one is only "qualified" to be a public arbitrator if somehow formerly affiliated with the securities industry but sufficiently removed from the securities industry[138] to cease being biased in favor of the securities industry. This

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[135] NASD CODE OF ARBITRATION PROCEDURE Rule 10308(a)(5) (National Ass'n of Sec. Dealers, Inc. 1999); *see also* Notice of Filing of Proposed Rule Change Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, 63 Fed. Reg. at 40,761-62.

[136] Notice of Filing of Proposed Rule Change Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, 63 Fed. Reg. at 40,766.

[137] *Id.* The NASD's explanation fails to note that persons who have ceased to be associated with a broker, dealer, or commodities firm within the last three years cannot be classified as public arbitrators.

[138] This means three years if formerly associated with a broker, dealer, or a firm or person registered under the CEA, two years if a professional representing securities industry clients less than twenty percent of the time, and immediately if no longer employed by a bank or other financial institution.

would seem to make the public arbitrator pool even more suspect. Apparently, individuals are only qualified to be public arbitrators if, at some point in their careers, they were somehow affiliated with the securities industry. The ambiguity engendered by the use of the phrase "a person who is otherwise qualified to serve as an arbitrator" when defining the term "public arbitrator" in amended NASD Rule 10308(a)(5) seems to confirm the perception by investors that the NASD public arbitrator pool includes arbitrators affiliated with the securities industry and therefore may be perceived as biased in favor of the securities industry.

The classification rules of amended NASD Rule 10308, concerning spouses and family members of persons affiliated with the securities industry, now adequately support the underlying principle that all arbitrators, both public and securities industry, must be neutral with no affiliation or bias toward either party. Amended NASD Rule 10308(a)(5)(B) appropriately prohibits spouses and other household members of persons affiliated with the securities industry from serving as either public or securities industry arbitrators.[139] Under prior NASD Rule 10308(d), spouses and household members could serve as securities industry arbitrators.[140]

Specifically, amended NASD Rule 10308(a)(5) precludes spouses and immediate family members of current or retired members of the securities industry or a person engaged in any of the other types of business activities that require classification as a securities industry arbitrator from serving as public or securities industry arbitrators.[141] Amended NASD Rule 10308(a)(5)(B) defines the term "immediate family member" as follows:

> (i) a family member who shares a home with a person engaged in the conduct or activities [of a member of the securities industry or that require classification as a securities industry arbitrator];
>
> (ii) a person who receives financial support of more than 50 percent of his or her annual income from a person engaged in the conduct or activities [of a member of the securities industry or that require classification as a securities industry arbitrator]; or

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[139] *See* NASD CODE OF ARBITRATION PROCEDURE Rules 10308(a)(5)(A)(ii)-(a)(5)(B) (National Ass'n of Sec. Dealers, Inc. 1999); *see also* Notice of Filing of Proposed Rule Change Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, 63 Fed. Reg. at 40,762.

[140] *See* NASD CODE OF ARBITRATION PROCEDURE Rule 10308(d) (National Ass'n of Sec. Dealers, Inc. 1997) (amended 1998).

[141] *See* Notice of Filing of Proposed Rule Change Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, 63 Fed. Reg. at 40,766.

> (iii) a person who is claimed as a dependent for federal income tax purposes by a person engaged in the conduct or activities [of a member of the securities industry or that require classification as a securities industry arbitrator].[142]

According to the NASD, the term "immediate family member" used in amended NASD Rule 10308(a)(5)(B) was expanded to preclude such people from being included in the public and the securities industry arbitrator pools because *"such persons' economic interests are too closely tied to those of the securities or commodities industry, even though such spouses and immediate family members may not be directly involved in the relevant business activities."*[143] Moreover, the NASD stated that "[a] person who has a close familial, personal, or *economically dependent relationship* with an associated person may be viewed as possessing a bias in favor of the securities or commodities industry."[144] This is a crucial observation.

Based on the NASD's observation, the logical corollary would be that the NASD's entire arbitrator selection process, along with its arbitral forum, would reasonably be viewed by investors as biased in favor of the securities industry. The NASD is a member association and is funded by the dues paid by its members,[145] i.e., firms engaged in the securities business. These firms employ associated persons, i.e., individuals employed in the securities industry. As noted previously, in order to open a securities brokerage account with a member of the securities industry, investors must sign an agreement that requires them to bring any claims

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[142] NASD CODE OF ARBITRATION PROCEDURE Rule 10308(a)(5)(B)(i)-(iii) (National Ass'n of Sec. Dealers, Inc. 1999); *see also* Order Granting Approval to Proposed Rule Change Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, Exchange Act Release No. 34-40,555, 63 Fed. Reg. 56,670, 56,673 n.10 (1998); Notice of Filing of Proposed Rule Change Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, 63 Fed. Reg. at 40,762.

[143] Notice of Filing of Proposed Rule Change Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, 63 Fed. Reg. at 40,766-67 (emphasis added); *see also* Order Granting Approval to Proposed Rule Change Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, 63 Fed. Reg. at 56,673.

[144] Order Granting Approval to Proposed Rule Change Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, 63 Fed. Reg. at 56,673 (emphasis added).

[145] The NASD's membership "includes virtually every broker or dealer in" the United States. NATIONAL ASS'N OF SEC. DEALERS, INC., *supra* note 7, at 151, 1101 (setting forth Schedule A to the NASD By-Laws).

against members of the securities industry in securities industry sponsored arbitral forums, e.g., the NASD arbitral forum. These forums are funded and administered by members of the securities industry, the very members against whom claims are brought by investors. Therefore, investors are required to bring claims against securities industry members in an arbitral forum which is economically dependent on, and has a close relationship with, the securities industry. Accordingly, the entire arbitration process, especially the arbitrator selection method, conducted under the auspices of the NASD is rightly viewed by investors as biased in favor of the securities industry.

Amended NASD Rule 10308, like its predecessor, is under-inclusive because it fails to expressly include investment advisers and members of the securities industry in its definition of securities industry arbitrator. This means that persons who clearly would be viewed by investors as affiliated with the securities industry continue to be classified as public arbitrators in the NASD arbitrator pool.[146] Amended NASD Rule 10308 only classifies investment advisers as securities industry arbitrators in its arbitrator pool if they are employed by banks or other financial institutions and effect securities and commodities transactions or supervise such employees. However, these individuals would not be classified as securities industry arbitrators under amended NASD Rule 10308 if they did not effect securities or commodities transactions, i.e., did not purchase or sell securities and commodities or supervise individuals who buy or sell securities or commodities. Investment advisers who only advise their clients, but do not purchase or sell securities for their clients, would be classified as public arbitrators. In addition, it is unclear from the text of subsection (a)(4)(D) of amended NASD Rule 10308, whether the phrase "or other financial institution" would include investment advisers employed by investment companies, insurance companies, or others entities, excluding banks, that employ investment advisers. As a result, like its predecessor, amended NASD Rule 10308 would allow these securities professionals to be classified as public arbitrators in the NASD arbitrator pool. In this instance, amended NASD Rule 10308 fails to effectively address investor concerns of arbitrator bias because it permits persons

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[146] The Uniform Code and NYSE Rule 607 exclude investment advisers from their public arbitrator pools and classify these securities professionals as industry arbitrators. *See* Order Approving Proposed Rule Changes by the New York Stock Exchange, Inc., National Association of Securities Dealers, Inc., and the American Stock Exchange, Inc. Relating to the Arbitration Process and the Use of Predispute Arbitration Clauses, Exchange Act Release No. 34-26,805, 54 Fed. Reg. 21,144, 21,146 (1989).

clearly affiliated with the securities industry to be included in the NASD public arbitrator pool.

Amended NASD Rule 10308 continues to classify professionals as public arbitrators while leaving their firms free to represent securities industry clients with impunity.[147] As previously noted, economic ties between partners may give rise to an appearance of bias that should exclude such persons from the public arbitrator pool.[148] Economic ties have been recognized as a particularly powerful form of biasing influence.[149] Moreover, even the NASD acknowledged that such economically dependent relationships may give rise to an appearance of bias in favor of the securities industry.[150] Failure to exclude professionals whose firms or partners devote a significant amount of their work effort and derive the greatest source of consistent income from the securities industry would seemingly exacerbate investor concern of the pervasiveness of bias in favor of the securities industry in the NASD arbitrator selection process.

In summary, the arbitrator classification rules under amended NASD Rule 10308, like its predecessor, are fatally flawed. Except as noted in the preceding analysis, arbitrator classification rules under amended NASD Rule 10308 are also based on arbitrary assumptions and certain key terms remain either ambiguous or undefined. For example, the key terms of public and securities industry arbitrators continue to be defined in a manner that fails to assure investors that individuals reasonably perceived as closely affiliated with the securities industry are excluded from the NASD public arbitrator pool.

Again, the author concedes that arbitrary assumptions and ambiguity are probably unavoidable when attempting to classify individuals as either public or securities industry arbitrators. However, it is instructive to note

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147 *See* NASD CODE OF ARBITRATION PROCEDURE Rule 10308(a)(4)(C) (National Ass'n of Sec. Dealers, Inc. 1999).

148 *See* Order Approving Proposed Rule Changes by the New York Stock Exchange, Inc., National Association of Securities Dealers, Inc., and the American Stock Exchange, Inc. Relating to the Arbitration Process and the Use of Predispute Arbitration Clauses, 54 Fed. Reg. at 21,146.

149 *See* Allison, *supra* note 70, at 514.

150 *See* Notice of Filing of Proposed Rule Change Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, Exchange Act Release No. 34-40,261, 63 Fed. Reg. 40,761, 40,766-67 (1998); *see also* Order Granting Approval to Proposed Rule Change Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, Exchange Act Release No. 34-40,555, 63 Fed. Reg. 56,670, 56,673 (1998).

that investor perception of bias in favor of the securities industry in the arbitrator selection process is not an issue in the AAA arbitral forum. This is significant because, as previously noted, arbitrator classification rules under the AAA Code contain equally arbitrary assumptions and ambiguous key terms. Accordingly, investor perception that the AAA arbitrator selection process is not biased in favor of the securities industry is likely not based on the conciseness and clarity of the AAA Code arbitrator classification rules. This perceived lack of bias in favor of the securities industry is likely based on the fact that the AAA is independent from the securities industry. As previously noted, one of the basic principals in qualifying arbitrators is "that no single entity should establish qualifications for all [arbitrators] in all settings."[151]

Under amended NASD Rule 10308, the NASD, a securities industry association, continues to be the sole arbiter of who is admitted to the arbitrator pool and whether those admitted in the pool are classified as public or securities industry arbitrators. Moreover, the standards governing admittance to the NASD arbitrator pool remain a mystery. This set of circumstances, in the author's opinion, unavoidably fuels the perception of investors and their counsel that the NASD arbitrator selection process is biased in favor of the securities industry. In fact, counsel for investors are already concerned that the NASD presently will try to slant the whole arbitrator pool with a bias towards the securities industry and that even if the NASD's justifications for precluding arbitrators from its arbitrator pool seem reasonable on their face, they could give rise to similar unacceptable consequences.[152] This "result" is a pro-securities industry bias in the arbitrator selection process achieved through composition and classification of the NASD arbitrator pool. It seems that when arbitrators are admitted to a pool of arbitrators selected and classified by a securities industry association such as the NASD, individuals admitted to such an entity's arbitrator pool may be perceived as biased in favor of the securities industry no matter how the classification rules are crafted.

Again, the author strongly suggests that the only effective way to eliminate investor perception of pro-securities industry bias in the NASD arbitrator classification process is to remove the arbitrator selection process from the NASD arbitral forum to an arbitral forum that is independent from the securities industry. Moreover, given securities industry domination and

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[151] SPIDR COMM'N ON QUALIFICATIONS, SOCIETY OF PROF'LS IN DISPUTE RESOLUTION, *supra* note 95, at 1.

[152] *See generally* Scott Bernstein, *NASD "Streamlining" of the Arbitrator Pool*, PIABA Q., Dec. 1998, at 17.

control of the composition and classification of the NASD arbitrator pool, it is likely that even the implementation of the new list selection method under amended NASD Rule 10308 will fail to eradicate the perception of investors and their counsel that the NASD arbitrator selection process is biased in favor of the securities industry.

B. *Appointing Arbitrators Under Amended NASD Rule 10308*

The new list selection method and rotational selection rule prescribed in amended NASD Rule 10308 attempts to ensure selection of arbitrators by the parties rather than the NASD staff, i.e., the securities industry. Essentially, the goal appears to be the elimination of the enormous discretion previously exercised by NASD staff in the NASD arbitrator selection process. Under amended NASD Rule 10308, parties are provided lists of potential arbitrators (both public and securities industry arbitrators) from the NASD arbitrator pool and use these lists to express numerical preferences or rankings for the arbitrators on the lists in sequential order. These rankings are the basis upon which arbitrators are appointed to serve on a panel, "unless all ranked arbitrators decline to serve because they are unavailable, recuse themselves, or are disqualified because of conflicts of interest."[153] The lists of arbitrators forwarded to the parties are generated from an arbitrator database using a software program, the Neutral List Selection System (NLSS),[154] on a rotational basis.

The list selection method implemented by the NASD consists of one round rather than the three rounds recommended by the NASD Task Force.[155] The NASD states that there is an insufficient number of arbitrators in its arbitrator pool, given its large caseload, to implement a three-round list selection method.[156] The NASD asserts that even

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[153] Notice of Filing of Proposed Rule Change Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, 63 Fed. Reg. at 40,765; *see also* Order Granting Approval to Proposed Rule Change Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, 63 Fed. Reg. at 56,672.

[154] *See* NASD CODE OF ARBITRATION PROCEDURE Rule 10308(b)(4) (National Ass'n of Sec. Dealers, Inc. 1999); *see also* Notice of Filing of Proposed Rule Change Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, 63 Fed. Reg. at 40,765.

[155] *See* ARBITRATION POLICY TASK FORCE, *supra* note 1, at 94–96.

[156] *See* Notice of Filing of Proposed Rule Change Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, 63 Fed. Reg. at 40,765. As previously noted, the NASD's caseload is large because, in many cases, the predispute

implementing a two-round list selection method would be too costly and "would make the process of appointing arbitrators too lengthy."[157]

In summary, paragraphs (b) through (d) of amended NASD Rule 10308 provide for the composition of arbitrator panels, a list selection method to choose arbitrators to serve on arbitration panels, selection of arbitrators on the lists from the NASD arbitrator pool on a rotational basis, and a ranking process to reflect the preferences of the parties in selecting arbitrators to serve on NASD arbitration panels.

1. *Composition of Panels*

Under amended NASD Rule 10308, the number and type of arbitrators appointed to serve in cases involving disputes with investors remain basically unchanged and are based on the amount of the claim. For claims of $50,000 or less, one public arbitrator is appointed to serve on a panel.[158] For claims exceeding $50,000, three arbitrators are appointed to serve on a panel, and the majority must be public arbitrators.[159] If the amount of the claim is greater than $25,000 but less than $50,000, a party or an arbitrator may request a panel of three arbitrators composed of a majority of public arbitrators.[160] If the amount of the claim is $25,000 or less, only an arbitrator appointed to the case may request the appointment of a panel of three arbitrators composed of a majority of public arbitrators.[161] All panel compositions specified in amended NASD Rule 10308(b) may vary if both

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resolution agreement requires investors to arbitrate at the NASD.

[157] *Id.*

[158] *See* NASD CODE OF ARBITRATION PROCEDURE Rule 10308(b)(1)(A) (National Ass'n of Sec. Dealers, Inc. 1999); *see also* Order Granting Approval to Proposed Rule Change Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, 63 Fed. Reg. at 56,671.

[159] *See* NASD CODE OF ARBITRATION PROCEDURE Rule 10308(b)(1)(B) (National Ass'n of Sec. Dealers, Inc. 1999); *see also* Order Granting Approval to Proposed Rule Change Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, 63 Fed. Reg. at 56,671.

[160] *See* NASD CODE OF ARBITRATION PROCEDURE Rule 10308(b)(1)(A)(ii) (National Ass'n of Sec. Dealers, Inc. 1999); *see also* Order Granting Approval to Proposed Rule Change Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, 63 Fed. Reg. at 56,671.

[161] *See* NASD CODE OF ARBITRATION PROCEDURE Rule 10308(b)(1)(A)(i) (National Ass'n of Sec. Dealers, Inc. 1999); *see also* Order Granting Approval to Proposed Rule Change Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, 63 Fed. Reg. at 56,671.

parties agree.

2. *Placement of Arbitrators on Lists*

NLSS maintains a database of the NASD arbitrator pool, which identifies arbitrators in the pool as public or securities industry. Based on the information contained in its database, NLSS generates lists sent to the parties for ranking.[162] NLSS uses four factors to generate the lists of arbitrators provided to the parties for ranking. These four factors are as follows: arbitrator classification, hearing location code, rotation, and identified conflicts of interest.[163] To generate a list, NLSS does the following: (1) identifies arbitrators in its database by classification, i.e., as either public or industry arbitrators; (2) "identifies those arbitrators in the same hearing location as the arbitration"; (3) selects the public or industry arbitrators "who are located in the hearing location in rotation" from its database; and (4) excludes arbitrators "subject to a conflict of interest with one of the parties."[164]

NLSS sorts its database on a "first-in-first-out" basis in order to place arbitrators on the lists on a rotating basis.[165] For example, to generate a

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[162] *See* Notice of Filing of Proposed Rule Change Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, Exchange Act Release No. 34-40,261, 63 Fed. Reg. 40,761, 40,765 (1998); *see also* NASD CODE OF ARBITRATION PROCEDURE Rule 10308(b)(4) (National Ass'n of Sec. Dealers, Inc. 1999); Order Granting Approval to Proposed Rule Change Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, 63 Fed. Reg. at 56,671.

[163] *See* Notice of Filing of Proposed Rule Change Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, 63 Fed. Reg. at 40,768. Pursuant to paragraph (a)(4) of amended NASD Rule 10308, parties may also request that the computer sort for arbitrators with expertise in subject matter and type of security. There are 22 security subcategories. However, the Director of Arbitration is not obligated to provide arbitrators on the list with the requested expertise because they might be unavailable, excluded because of conflicts or because NLSS may not be coded for that particular subject matter. The Director of Arbitration or both parties may also request a sort by case expertise, i.e., those arbitrators with expertise in large and complex cases. In addition, "[a]t the request of a party, the Director [of Arbitration] can add a procedure that is outside the NLSS capability, but that may legitimately be considered in the selection of an arbitration panel." Order Granting Approval to Proposed Rule Change Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, 63 Fed. Reg. at 56,681 n.90.

[164] Notice of Filing of Proposed Rule Change Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, 63 Fed. Reg. at 40,768.

[165] *Id.* at 40,768 n.29; *see also* Order Granting Approval to Proposed Rule

one-person public arbitrator panel, as the public arbitrator's name rises to the top of the list in a particular hearing location, the arbitrator's name will be put on a list to be sent to the parties, absent a conflict of interest with one of the parties. After the arbitrator's name is sent to parties on a list, the arbitrator's name is placed at the bottom of NLSS's database.[166] An arbitrator's name is placed on the bottom of the NLSS database even if she is recused, is not ranked highly enough by the parties to serve, is struck by the parties, or is ranked highly enough to serve but is unavailable to serve.[167] For a three-person panel requiring two public arbitrators and one securities industry arbitrator, the list forwarded to the parties for ranking would be generated in the same manner. When generating the list of securities industry arbitrators, the names of the first five securities industry arbitrators in the designated hearing location on the NLSS database would be selected or "rotated forward"[168] for placement on the list to be forwarded to the parties for ranking.[169] Prior to forwarding this list to the parties, arbitrators on the list next would be reviewed for possible conflicts of interest.

> [F]or example, [if] the case is against Firm X and the first person that NLSS generates, Arbitrator A51000, is employed by Firm X, NLSS will not select Arbitrator A51000 but will skip over [him] or her and will list the next person classified as a [securities industry] arbitrator. Arbitrator A51000 will remain at the top of the internal NLSS rotating list for [securities industry] arbitrators, and the NLSS will generate his or her name when next requested to produce the names of [securities industry] arbitrators for a case in the same hearing location.[170]

Change Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, 63 Fed. Reg. at 56,674 n.22.

[166] *See* Notice of Filing of Proposed Rule Change Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, 63 Fed. Reg. at 40,768 n.29.

[167] *See id.*

[168] *Id.*

[169] It should be noted that for a one-person panel, NLSS can only generate a list for either public or securities industry arbitrators. For a three-person panel, NLSS can only generate lists for a panel composed of one securities industry arbitrator and two public arbitrators or three securities industry arbitrators. *See* Order Granting Approval to Proposed Rule Change Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, 63 Fed. Reg. at 56,673.

[170] Notice of Filing of Proposed Rule Change Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, 63 Fed. Reg. at 40,768 n.29.

Neither the text of amended NASD Rule 10308 nor its Commentary fully describes the types of conflict of interests identified by NLSS. According to the NASD, the NLSS can only select or sort for "a clear conflict of interest with one of the parties,"[171] i.e., "only obvious, disclosed conflicts of interest."[172] The NASD identifies two of these "clear conflicts of interest" as cases in which the respondent is the employer of an arbitrator[173] or has a securities account with the respondent;[174] in such cases, NLSS would not place the arbitrator on the list it generates that is forwarded to the parties for ranking.[175]

It is essential that public customers, and their counsel, understand precisely the types of conflicts of interest identified by NLSS in its sorting or selection process. Failure to adequately describe the types of conflicts of interest identified in the sorting process may only fuel investor perception that the arbitrator selection process remains biased in favor of the securities industry. Information currently provided in amended NASD Rule 10308 and its Commentary is woefully inadequate.

The NASD also attempts in amended NASD Rule 10308 to ensure that arbitrators are placed on the lists forwarded to parties for ranking with the same regularity,[176] i.e., to prevent some arbitrators from being placed on lists forwarded to the parties for ranking more frequently than others. Specifically, NLSS assigns the arbitrator who has taken part in the fewest list selection processes a higher rotation number than an arbitrator who has participated in more list selection processes. This means, for example, that a public arbitrator from Atlanta, Georgia who has participated in the list selection process five times would be listed before a public arbitrator from Atlanta, Georgia who had participated seven times in the selection process if both were generated for the same list.[177]

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[171] *Id.* at 40,768.

[172] *Id.* at 40,768 n.30.

[173] *Id.*

[174] *See* Order Granting Approval to Proposed Rule Change Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, 63 Fed. Reg. at 56,680 n.76.

[175] *See* Notice of Filing of Proposed Rule Change Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, 63 Fed. Reg. at 40,768 n.30.

[176] *See* Order Granting Approval to Proposed Rule Change Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, 63 Fed. Reg. at 56,681.

[177] *See* Notice of Filing of Proposed Rule Change Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, 63 Fed. Reg. at 40,768 n.29.

The rotational rule implemented under amended NASD Rule 10308 substantially conforms with the NASD Task Force's recommendation that arbitrators be placed on lists forwarded to the parties on a rotating basis. According to the NASD Task Force, "the NASD should attempt to offer qualified arbitrators as candidates on a rotating basis" and "should monitor the frequency with which individual arbitrators are listed and selected."[178] Amended NASD Rule 10308's rotational selection rule aids in eliminating investor perception that the NASD arbitrator selection process under prior NASD Rule 10308 allowed repeated selection of arbitrators whose decisions seemed to favor the securities industry.[179]

Using a software program to generate the list of arbitrators rather than relying solely on NASD staff judgment helps to lessen the perception of bias in favor of the securities industry in the arbitrator selection process. Selecting arbitrators in rotation would seemingly reduce NASD staff discretion in placing arbitrators on the lists forwarded to the parties for ranking. However, NASD staff[180] discretion has been interposed in amended NASD Rule 10308's rotational rule when determining whether to place an arbitrator on the list because of conflicts of interest. NASD staff performs a manual review for conflicts of interest before the lists are sent to the parties. This manual review consists of, among other things, reviewing information found in the Central Registration Depository (CRD)[181] (only for securities industry arbitrators) and information disclosed by arbitrators to NASD staff. NASD staff does not contact the arbitrators on the list generated by NLSS during its manual review. Most importantly, NASD staff may remove an arbitrator from the list as a result of its manual

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[178] ARBITRATION POLICY TASK FORCE, *supra* note 1, at 97.

[179] *See* PIABA, *supra* note 1, at 10-11. The author notes that the NASD Task Force made this recommendation to "promote more frequent selection of arbitrators who complete the arbitrator training programs." ARBITRATION POLICY TASK FORCE, *supra* note 1, at 97. Currently all new arbitrators are required to complete an arbitrator training seminar and to successfully complete a test on the materials covered in the training seminar before serving as an arbitrator in any arbitration proceeding.

[180] The author recognizes that NASD staff referred to in this Article would be employees of NASDR, the NASD subsidiary to which the NASD has delegated the responsibility of administering its arbitral forum.

[181] The CRD is an online registration and licensing data bank and an application-processing facility. It maintains the qualification, employment, and disclosure (including disciplinary history) of the more than half a million registered securities employees of NASD member firms. *See* Central Registration Depository, *Central Registration Depository (CRD) System* (last modified Oct. 14, 1999) <http://www.nasdr.com/3400.htm>.

review before the lists are forwarded to the parties for ranking. During the review, NASD staff determines, in its sole discretion, whether to remove arbitrators from the list generated by NLSS even though NLSS was designed to reduce, if not eliminate, NASD staff discretion in the arbitrator selection process. Although amended NASD Rule 10308 does not contain an express standard for determining conflicts of interest requiring disqualification,[182] the NASD asserts that "[a]ny time that a Director [of Arbitration] must resolve a disqualification issue, the Director [of Arbitration] will refer to" the applicable provisions of *The Arbitrator's Manual* and *Code of Ethics for Arbitrators in Commercial Disputes*.[183] However, these documents contain general prescriptions and allow, if not require, the exercise of discretion by the Director of Arbitration in their application. Accordingly, the manual review performed by NASD staff injects, unnecessarily, NASD staff judgment back into the arbitrator selection process.

Moreover, to successfully eliminate perceived pro-securities industry bias, this type of review probably should be conducted only by the parties. The Director of Arbitration under current NASD Rule 10312(e) is required to disclose to all parties information disclosed by arbitrators to the Director of Arbitration relating to financial interests or relationships which might preclude the arbitrator from rendering a fair and impartial decision, *unless the arbitrator voluntarily withdraws*[184] *or the Director of Arbitration determines to remove him or her*;[185] this presumably would include information obtained from the CRD as well as information obtained from any other source. If the arbitrator decides not to withdraw, this information should be given to the parties so that they, rather than NASD staff, are given the opportunity to identify conflicts of interest based on information obtained by NASD staff in its manual review. If a party identifies a conflict of interest based on such information, the party's remedy is to strike the person from the list. Use of discretion or judgment by NASD staff would most likely be viewed, at least by investors, as another instance of

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[182] *See* Order Granting Approval to Proposed Rule Change Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, Exchange Act Release No. 34-40,555, 63 Fed. Reg. 56,670, 56,680 (1998).

[183] *See* THE ARBITRATOR'S MANUAL, *supra* note 2, at 5–6, 42–44; *see also supra* note 104 (setting forth the same standards for conflicts of interests).

[184] *See* Order Granting Approval to Proposed Rule Change Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, 63 Fed. Reg. at 56,672, 56,677 n.45.

[185] *See id.* at 56,677.

securities industry domination and control, resulting in an arbitrator selection process biased in favor of the securities industry.

Neither the text of amended NASD Rule 10308 nor its Commentary states how arbitrators currently in the NASD arbitrator pool or subsequently added to the NASD arbitrator pool would be initially ranked or positioned in the NLSS database, i.e., prior to being placed on a list forwarded to the parties for ranking. Specifically, it is unclear how arbitrators currently in the NASD arbitrator pool would be initially positioned in the NLSS database or how arbitrators subsequently added to the NASD arbitrator pool would be positioned or ranked relative to those already in the pool. The Commentary only addresses the operation of the NLSS selection process after arbitrators in the NASD pool of arbitrators have initially been assigned positions in the NLSS database.[186] It is essential that the initial positioning of arbitrators in the NLSS database be perceived by investors as fair and unbiased. The Public Investors Arbitration Bar Association (PIABA), in its filing with the Commission, has appropriately recognized this issue and suggests that arbitrators initially should be positioned in the database on a random basis and assigned a permanent number; arbitrators subsequently added to the pool then would be assigned the next available number.[187] After being positioned in the NLSS database on a random basis, arbitrators then could be placed on lists forwarded to the parties for ranking on a rotating basis. Whatever the method adopted for initially positioning arbitrators in the NLSS database, it must be free from even the appearance of impropriety; if not, it will be yet another instance in which public customers can reasonably perceive that the arbitrator selection process is biased in favor of the securities industry. In fact, attorneys representing investors assert that the NASD is currently engaged in a "streamlining" of its existing arbitrator pool; specifically, they assert that the NASD is eliminating some of the arbitrators in its arbitrator pool who have provided services to investors with claims against members

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[186] The NASD states that arbitrators are assigned an identification number in the NLSS database as they "enter the system"; it does not indicate whether the arbitrator identification number coincides with the arbitrator's position or ranking in the NLSS database. Notice of Filing of Proposed Rule Change Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, Exchange Act Release No. 34-40,261, 63 Fed. Reg. 40,761, 40,771 n.46 (1998). The NASD Task Force also failed to address this issue. In its report, it failed to specify how to implement its recommendation of the use of a rotational selection rule.

[187] *See* PIABA, *supra* note 1, at 14–15.

of the securities industry.[188]

3. *Party Ranking of Arbitrators*

The parties receive and must rank arbitrators on lists generated by NLSS. The Director of Arbitration sends lists generated by NLSS from the NASD arbitrator pool, and manually reviewed by NASD staff, to the parties. Only one list of public arbitrators is sent to all the parties for a panel of one arbitrator, unless the parties agree to a different panel composition.[189] Two lists, one containing public arbitrators and one containing securities industry arbitrators, are sent to the parties for a panel of three arbitrators.[190] For a panel of three arbitrators, the lists must contain, "to the extent possible," the names of public and securities industry arbitrators in a two-to-one ratio, respectively.[191] For example, if the securities industry arbitrator list contained five names, the public arbitrator list would contain ten names. However, if the available roster of arbitrators is insufficient, the Director of Arbitration would send a list of public arbitrators containing not less than six names and a securities industry arbitrator list containing not less than three names.[192]

The composition of lists sent to parties for ranking under amended NASD Rule 10308 differs from the NASD Task Force's recommendation in that parties would receive three lists of arbitrators instead of two lists of arbitrators for a panel of three arbitrators. Under the NASD Task Force recommendation, parties would receive the following three lists of candidates: "(i) a list of public arbitrators qualified to be panel chairs to contain no fewer than three names; (ii) a list of other public arbitrators, to contain no fewer than five names; and (iii) a list of securities industry

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[188] *See generally* Bernstein, *supra* note 152.

[189] *See* NASD CODE OF ARBITRATION PROCEDURE Rule 10308(b)(2) (National Ass'n of Sec. Dealers, Inc. 1999); *see also* Notice of Filing of Proposed Rule Change Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, 63 Fed. Reg. at 40,762.

[190] *See* NASD CODE OF ARBITRATION PROCEDURE Rule 10308(b)(3) (National Ass'n of Sec. Dealers, Inc. 1999); *see also* Notice of Filing of Proposed Rule Change Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, 63 Fed. Reg. at 40,762.

[191] Notice of Filing of Proposed Rule Change Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, 63 Fed. Reg. at 40,761.

[192] *See id.*

arbitrators, to contain no fewer than five names."[193] The NASD Task Force recommends two lists or categories of public arbitrators because it believes that at least one of the public arbitrators, the chairperson of the arbitration panel, must have a "strong command of NASD arbitration procedure and general arbitration techniques, as well as familiarity with industry practices and substantive law."[194] However, the author suggests that two list categories consisting of public arbitrators and securities industry arbitrators most likely are sufficient; three list categories might unnecessarily prolong the selection process, thus undermining the efficiency and speed of the arbitration process.[195]

Under amended NASD Rule 10308, the lists of arbitrators are sent[196] "to all parties at the same time[,] approximately thirty days after the last answer is due."[197] The parties must be provided with the employment history of arbitrators on the list for the past ten years and "other background information."[198]

Parties may strike one or all the arbitrators on the list for any reason and are required to rank any names remaining on the lists by assigning a different numerical, sequential ranking to each arbitrator.[199] The numeral

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[193] ARBITRATION POLICY TASK FORCE, *supra* note 1, at 95.

[194] *Id.* at 111.

[195] The NASD Task Force's recommendation as to the qualifications of a panel chairperson seems designed to address the quality of arbitrators and not the impartiality of the arbitrator selection process, which is at issue in this Article.

[196] "Send" means to send by first class mail, facsimile, or any other method available and convenient to the parties and the Director of Arbitration. *See* NASD CODE OF ARBITRATION PROCEDURE Rule 10308(a)(7) (National Ass'n of Sec. Dealers, Inc. 1999); *see also* Notice of Filing of Proposed Rule Change Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, 63 Fed. Reg. at 40,762.

[197] NASD CODE OF ARBITRATION PROCEDURE Rule 10308(b)(5) (National Ass'n of Sec. Dealers, Inc. 1999); *see also* Notice of Filing of Proposed Rule Change Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, 63 Fed. Reg. at 40,762. Generally, the answer is due within 20 days from the receipt of the statement of claim. *See* NASD CODE OF ARBITRATION PROCEDURE Rule 10314(b)(1) (National Ass'n of Sec. Dealers, Inc. 1999).

[198] NASD CODE OF ARBITRATION PROCEDURE Rule 10308(b)(6) (National Ass'n of Sec. Dealers, Inc. 1999); *see also* Order Granting Approval to Proposed Rule Change Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, Exchange Act Release No. 34-40,555, 63 Fed. Reg. 56,670, 56,671 (1998). The text of NASD Rule 10308(b)(6) does not define the phrase "other background information." Accordingly, it is unclear what type of other background information must be provided to the parties.

[199] *See* NASD CODE OF ARBITRATION PROCEDURE Rule 10308(c)(1) (National

"one" indicates a party's first choice.[200] The parties must return the lists ranking the arbitrators no later than twenty days after the Director of Arbitration sends the lists to the parties, unless the Director of Arbitration extends this period.[201] If any party fails to return the lists within twenty days, the Director of Arbitration will assume that the party accepted all the arbitrators on the lists and has no preferences.[202] However, if a party fails to rank an arbitrator on the list, "the Director of Arbitration will assign the [unranked] arbitrator the next lower ranking after the lowest-ranked arbitrator on that list."[203] For example, if a party ranks arbitrators on a list containing five securities industry arbitrators by striking two and ranking arbitrators A and B as "one" and "two" respectively, but fails to rank arbitrator C, the Director would assign arbitrator C a ranking of "three."[204] The assignment of a rank on behalf of a party by the Director of Arbitration reasonably may be perceived by investors as permitting too much discretion in the arbitrator selection process by a securities industry sponsored arbitral forum. Moreover, the Director of Arbitration is required to assume that the party intended to rank the arbitrator instead of striking the arbitrator. If a party fails to rank two or more arbitrators on the same list or gives two or more arbitrators on the same list the same numerical ranking, the Director of Arbitration ranks the multiple, unranked arbitrators and the arbitrators with the same numerical ranking in the same order of preference in which they appeared on the original list sent to the parties.[205]

Ass'n of Sec. Dealers, Inc. 1999); *see also* Order Granting Approval to Proposed Rule Change Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, 63 Fed. Reg. at 56,671.

[200] *See* Order Granting Approval to Proposed Rule Change Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, 63 Fed. Reg. at 56,671.

[201] *See* NASD CODE OF ARBITRATION PROCEDURE Rule 10308(c)(2) (National Ass'n of Sec. Dealers, Inc. 1999); *see also* Notice of Filing of Proposed Rule Change Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, 63 Fed. Reg. at 40,763. Parties may request additional information, but the time for returning the lists is not automatically tolled. This means that the parties' ability to identify conflicts and to participate intelligently in the striking and ranking process may be adversely affected because they may not have the necessary information before the lists must be returned to the NASD.

[202] *See* Notice of Filing of Proposed Rule Change Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, 63 Fed. Reg. at 40,763.

[203] *Id.* at 40,770.

[204] *See id.*

[205] *See id.*

This procedure inappropriately treats a failure to rank multiple arbitrators and the assignment of the same ranking to multiple arbitrators in the same manner. It also prohibits a party from having an equal preference for arbitrators on the list and assumes that, if a party fails to assign a ranking for two or more arbitrators, the party has a preference and did not intend to strike the two arbitrators. This particular procedure reasonably may be perceived by investors as, again, a reflection of NASD staff bias and prejudgment in the arbitrator selection process; it allows the securities industry discretion in the ranking process of the parties by substituting the judgment of the securities industry for the parties. A better procedure might include contacting the parties to determine their intent or assuming that the parties meant to strike unranked arbitrators and allowing the parties to assign the same numerical ranking to multiple arbitrators. Because the goal is to permit the parties, rather than NASD staff, to select the arbitrators, striking unranked arbitrators and permitting parties to assign the same numerical ranking to multiple arbitrators would seem to have a less adverse impact on the choices of the parties in the ranking process, rather than permitting the Director of Arbitration to decide that the parties would have ranked the arbitrators on the list in a certain manner.

4. *Consolidation of Party Rankings*

Generally, the rankings of the parties are consolidated by the Director of Arbitration, using NLSS,[206] into one list or two lists (if the panel will consist of three arbitrators) reflecting the names of those arbitrators acceptable to all parties.[207] The consolidation process is a one-step process if all parties filing a single claim are treated as one claimant and all

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[206] The Director of Arbitration can use only NLSS in the consolidation process for certain panel combinations. NLSS can consolidate the rankings for a one-person panel of either public or securities industry arbitrators; for a three-person panel, NLSS can consolidate the rankings for a panel composed of one securities industry arbitrator and two public arbitrators or three securities industry arbitrators. *See* Order Granting Approval to Proposed Rule Change Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, Exchange Act Release No. 43-40,555, 63 Fed. Reg. 56,670, 56,673 (1998).

[207] As previously noted, this may not be the case if one or more of the parties fails to rank or to strike a name on the original list generated by NLSS, manually reviewed by NASD staff, and forwarded to the parties for ranking; the Director of Arbitration makes certain assumptions about how the parties would have ranked the arbitrators on the list if they had not failed to rank or strike these arbitrators from the list.

respondents filing a single answer are treated as one respondent.[208] It is a two-step process if there are multiple claimants or respondents filing multiple claims or answers, respectively,[209] but the Director of Arbitration determines that the interests of all claimants or all respondents are substantially the same.[210] The two-step consolidation process can be avoided if multiple claimants cooperate by submitting one ranked list to which all claimants jointly agree, and multiple respondents cooperate by submitting one ranked list to which all respondents jointly agree. In the one-step consolidation process, the rankings of the claimant and the respondent are added together, and the arbitrator with the lowest total (the number one indicates the highest ranking by a party) is positioned first on the consolidated list; the arbitrator with the next lowest total is positioned second on the consolidated list and so on.

Table 1. Ranking Process

Arbitrator Name	Original List Position	Consolidated Claimant Ranking	Consolidated Respondent Ranking	Total	Consolidated Rank
R. Jones	1	1	6	7	4
S. Sampson	2	strike	7	0	0
B. White	3	2	1	3	1
L. Herbert	4	3	5	8	5
A. Hunt	5	4	2	6	3
C. Holden	6	2	3	5	2

The Director of Arbitration, using NLSS, creates a single consolidated list of public arbitrators, and if a panel of three arbitrators is required, a second list of securities industry arbitrators. If there is a numerical tie between two or more arbitrators, NLSS breaks the tie first by preferentially ranking the arbitrator that has the smallest numerical difference between the claimant ranking and the respondent ranking. If the numerical difference is the same, the arbitrator listed higher on the list originally generated by NLSS, manually reviewed by NASD staff, and sent to the parties will be

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[208] *See* Notice of Filing of Proposed Rule Change Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, Exchange Act Release No. 34-40,261, 63 Fed. Reg. 40,761, 40,770 (1998).

[209] *See id.*

[210] *See id.*; NASD CODE OF ARBITRATION PROCEDURE Rule 10308(c)(3)(A) (National Ass'n of Sec. Dealers, Inc. 1999).

ranked higher on the consolidated list.[211]

Table 2. Numerical Ties

Arbitrator Name	Original List Position	Consolidated Claimant Ranking	Consolidated Respondent Ranking	Total	Consolidated Total	Difference
R. Hunt	1	1	6	7	1	n/a
S. Jones	2	3	5	8	3	2
P. James	3	4	4	8	2	0
A. White	4	5	3	8	4	2
C. Black	5	6	2	8	5	4

In the two-step process, first, the rankings of all claimants are added together and the rankings of all respondents are added together;[212] this assumes that each claimant and each respondent submitted separate ranked lists to the Director of Arbitration, i.e., they did not cooperate in the ranking process. Next, the combined totals for all claimants are added to the combined totals of all respondents, and the arbitrator with the lowest numerical total is positioned first on the consolidated list, the arbitrator with the next lowest numerical total is positioned second on the list, and so on.[213] The Director of Arbitration, using NLSS, then creates a single consolidated list of public arbitrators or two consolidated lists consisting of public arbitrators and securities industry arbitrators (for panels with three arbitrators only) as described in the preceding paragraph for the one-step process.

Finally, the consolidation process makes no provision for party participation in the arbitrator selection process if a party is added after the consolidated lists have been prepared but before the initial hearing or prehearing conference has occurred. Amended NASD Rule 10308 allows an additional party to participate in the list selection process before the Director of Arbitration has consolidated the other parties' rankings.[214]

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[211] *See* Notice of Filing of Proposed Rule Change Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, 63 Fed. Reg. at 40,771–72.

[212] The NASD asserts that "consolidating the rankings of parties on the same side . . . ensures that claimants' and respondents' choices will have the same weight in the arbitrator selection process." *Id.* at 40,770.

[213] *See supra* tbl.1.

[214] *See* NASD CODE OF ARBITRATION PROCEDURE Rule 10308(c)(6) (National Ass'n of Sec. Dealers, Inc. 1999); *see also* Notice of Filing of Proposed Rule Change

However, it makes no provision for additional parties after the parties' rankings have been consolidated but before the initial hearing or prehearing conference, whichever occurs first. Such parties will only be included in the arbitrator selection process if they become a party to the proceeding before the Director of Arbitration has consolidated the other parties' rankings.

5. *The Arbitrator Appointment Process*

The Director of Arbitration appoints arbitrators to serve on arbitration panels based on the order of rankings on the consolidated list (or two lists for a panel requiring three arbitrators) subject to disqualification and availability.[215] Before appointing arbitrators from the consolidated list to serve on a panel, the Director of Arbitration must contact the arbitrators to determine availability and whether there are conflicts of interest or bias or any other reason that the arbitrator would not be able to serve on the panel.[216] The Director of Arbitration begins by contacting the arbitrator ranked highest on the consolidated list. After this initial contact with the arbitrator, only the Director of Arbitration determines whether to disqualify the arbitrator "based upon that information the arbitrator has previously provide[d], any information provided to the Director [of Arbitration] under [current] Rule 10312,[217] and any information obtained from any other source."[218] If the arbitrator is not disqualified and is available, the Director of Arbitration would appoint the arbitrator to the panel. If the arbitrator is disqualified or unavailable, the Director of Arbitration would contact the

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Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, 63 Fed. Reg. at 40,763.

[215] *See* Notice of Filing of Proposed Rule Change Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, 63 Fed. Reg. at 40,763, 40,772; NASD CODE OF ARBITRATION PROCEDURE Rule 10308(c)(4)(A) (National Ass'n of Sec. Dealers, Inc. 1999).

[216] *See* Notice of Filing of Proposed Rule Change Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, 63 Fed. Reg. at 40,763.

[217] Current NASD Rule 10312 requires arbitrators to disclose information relating to financial interests or relationships which might preclude the arbitrator from rendering a fair and impartial decision. *See* Order Granting Approval to Proposed Rule Change Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, Exchange Act Release No. 34-40,555, 63 Fed. Reg. 56,670, 56,677–78 (1998).

[218] Notice of Filing of Proposed Rule Change Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, 63 Fed. Reg. at 40,772.

next highest ranked arbitrator on the consolidated list and would continue to do so until a full panel could be appointed.[219] The Director of Arbitration allows a reasonable time frame for the arbitrator to respond to this initial contact before contacting the next arbitrator on the consolidated list.[220]

Party participation in the arbitrator selection process may be undermined under amended NASD Rule 10308 because NASD staff discretion is exercised after the lists are consolidated but before the arbitrators on the consolidated list are appointed to serve on a panel. It is in the sole discretion of the Director of Arbitration whether to disqualify an arbitrator on the consolidated list before appointing the arbitrator to serve on a panel. In essence, the parties' selections may be expunged if the Director of Arbitration determines that the arbitrator is disqualified based, possibly, on information to which only the Director of Arbitration may have access. Investors may reasonably perceive such discretion at this stage of the arbitrator selection process as an opportunity for NASD staff to weaken or undermine their participation in the arbitrator selection process. It is suggested that if an arbitrator is available to serve on an arbitration panel, parties should be given all the information obtained by the Director of Arbitration when contacting the arbitrators. Based on this additional information, parties should be allowed to make the initial determination as to whether a conflict of interest or bias exists which would preclude the arbitrator from rendering a fair and impartial decision. Instead, this initial determination is made in the sole discretion of NASD staff.

If the number of arbitrators available to serve from the consolidated list is insufficient to fill a panel, NASD staff discretion, once again, determines which arbitrators are appointed to serve on a panel.[221] The Director of Arbitration is permitted to appoint arbitrators not on a consolidated list if the number of arbitrators available to serve from a consolidated list is insufficient to complete a panel.[222] However, the parties, at this stage of the

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219 *See id.* at 40,763.

220 *See id.* at 40,762. Neither the text nor the commentary of proposed Rule 10308 states this time frame; the commentary describes this time frame as "appropriate, but relatively brief." *Id.* at 40,772.

221 *See* NASD CODE OF ARBITRATION PROCEDURE Rule 10308(c)(4)(B) (National Ass'n of Sec. Dealers, Inc. 1999); *see also* Order Granting Approval to Proposed Rule Change Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, 63 Fed. Reg. at 56,671.

222 *See* NASD CODE OF ARBITRATION PROCEDURE Rule 10308(c)(4)(B) (National Ass'n of Sec. Dealers, Inc. 1999); *see also* Order Granting Approval to Proposed Rule Change Relating to the Selection of Arbitrators in Arbitrations Involving Public

process, may request only that the arbitrator appointed by the Director of Arbitration be disqualified; this request must be unanimous, in writing, and made within fifteen days of being notified of the Director of Arbitration's appointment.[223] Apparently, if the one-round list selection method fails, parties are allowed even less participation in the arbitrator selection process under amended NASD Rule 10308 than under its predecessor. Prior NASD Rule 10308 allowed one peremptory challenge and unlimited challenges for cause.[224] Amended NASD Rule 10308 only allows challenges for cause.[225] Only allowing the parties to request the disqualification of an arbitrator appointed in the sole discretion of the Director of Arbitrator does not facilitate the goal of eliminating at least the perception of securities industry bias in the arbitrator selection process. In contrast, AAA Rule 14 allows at least one peremptory challenge and unlimited challenges for cause.[226]

Implementation of the NASD Task Force's recommendation of a three-round list selection method might better address the issue of failure to obtain sufficient arbitrators to appoint a panel.[227] Under the list selection

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Customers, 63 Fed. Reg. at 56,671. The Director of Arbitration cannot appoint a securities industry arbitrator, unless a securities industry arbitrator is requested by the parties. *See* NASD CODE OF ARBITRATION PROCEDURE Rule 10308(c)(4)(B) (National Ass'n of Sec. Dealers, Inc. 1999); *see also* Order Granting Approval to Proposed Rule Change Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, 63 Fed. Reg. at 56,671. In addition, the Director of Arbitration is prohibited from appointing a securities industry arbitrator who has either retired from the securities industry or is a professional devoting 20% or more of his work effort to securities industry clients within the last two years. *See* NASD CODE OF ARBITRATION PROCEDURE Rules 10308(a)(4), 10308(c)(4)(B) (National Ass'n of Sec. Dealers, Inc. 1999).

[223] *See* NASD CODE OF ARBITRATION PROCEDURE Rule 10308(b)(6) (National Ass'n of Sec. Dealers, Inc. 1999); *see also* Order Granting Approval to Proposed Rule Change Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, 63 Fed. Reg. at 56,671.

[224] *See* NASD CODE OF ARBITRATION PROCEDURE Rule 10308 (National Ass'n of Sec. Dealers, Inc. 1999) (amended 1998).

[225] *See* NASD CODE OF ARBITRATION PROCEDURE Rule 10308(c)(1)(A) (National Ass'n of Sec. Dealers, Inc. 1999).

[226] *See* SEC. ARBITRATION Rule 14 (American Arbitration Ass'n 1993). Under the AAA Code a limited number of names are also submitted to the parties and each party is allowed to strike, on a peremptory basis, one name for each arbitrator to be appointed. *See id.*

[227] *See* ARBITRATION POLICY TASK FORCE, *supra* note 1, at 111 (stating that "we are concerned that there will not be a sufficient number of qualified chairs to meet the needs of the NASD's expanding caseloads").

method recommended by the NASD Task Force, each party strikes names from any of the lists and then ranks the remaining names on each list in order of preference. If there are an insufficient number of mutually agreeable arbitrators to complete a panel new lists would be provided for each category (public arbitrator or securities industry arbitrator) in which agreement was not reached. This process would continue for no more than three rounds.[228] Providing the parties with three opportunities to select a panel and allowing unlimited strikes in each round is more effective in ensuring that the parties, rather than NASD staff, determine the arbitrators appointed to serve on panels.

However, the NASD Task Force's recommended procedure for selecting arbitrators, should a panel not be completed within the three rounds, injects unacceptable NASD staff discretion into the arbitrator selection process once again. "If, at the end of the three rounds, a [securities] industry and two public arbitrators[229] . . . ha[ve] not been chosen, the Director [of Arbitration] would appoint the remaining" arbitrator(s) who could "only be challenged for cause."[230] Using the procedure specified in AAA Rule 14 of submitting a short list of names per vacancy and allowing a single peremptory challenge[231] probably would be more effective in achieving the goal of arbitrator selection by the parties rather than by NASD staff.

In securities industry sponsored arbitration forums, it is essential to the perceived fairness of the arbitration process itself that the arbitrator selection process, and therefore the composition of the arbitrator panels, reflect the choices of both parties and not the choices of one predominant party—the securities industry. Unfortunately, this has not been achieved in the arbitrator appointment process under amended NASD Rule 10308. If the one-round list selection method results in an insufficient number of arbitrators to complete a panel, the NASD, rather than the parties, determines which arbitrators are appointed to serve on a panel.[232]

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[228] *See id.* at 95.

[229] "[O]ne qualified as a panel chair." *Id.*

[230] *Id.* In addition, the NASD Task Force notes that unlimited strikes are not recommended until a panel is chosen, given the relatively small size of the NASD arbitrator pool at the time of its report.

[231] *See* SEC. ARBITRATION Rule 14 (American Arbitration Ass'n 1993).

[232] *See* Order Granting Approval to Proposed Rule Change Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, Exchange Act Release No. 34-40,555, 63 Fed. Reg. 56,670, 56,683 (1998).

6. *Selecting Chairpersons*

Parties are allowed only a limited opportunity to select the chairperson of the arbitration panel. The parties have only fifteen days to appoint a chairperson from the date the Director of Arbitration sends notice of the names of the arbitrators appointed to serve on the panel.[233] If the parties cannot agree on whom to appoint as chairperson, the Director of Arbitration appoints the chairperson of the panel.[234] Significantly, the Director of Arbitration is prohibited from appointing as chairperson attorneys or other professionals who have devoted fifty percent or more of their work effort to representing investors in disputes with members of the securities industry. Specifically, paragraph (c)(5) of amended NASD Rule 10308 states that:

> (A) The Director shall appoint as the chairperson the public arbitrator who is the most highly ranked by the parties as long as the person is not an attorney, accountant, or other professional who has devoted [fifty percent] or more of his or her professional or business activities, within the last two years, to representing or advising public customers in matters relating to disputed securities or commodities transactions or similar matters.
>
> (B) If the most highly ranked public arbitrator is subject to the exclusion set forth in subparagraph (A), the Director shall appoint as the chairperson the other public arbitrator, as long as the person also is not subject to the exclusion set forth in subparagraph (A).
>
> (C) If both public arbitrators are subject to the exclusion set forth in subparagraph (A), the Director shall appoint as the chairperson the public arbitrator who is the most highly ranked by the parties.[235]

Moreover, paragraph (c)(5) of amended NASD Rule 10308 would also

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[233] *See* NASD CODE OF ARBITRATION PROCEDURE Rule 10308(c)(5) (National Ass'n of Sec. Dealers, Inc. 1999); *see also* Order Granting Approval to Proposed Rule Change Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, 63 Fed. Reg. at 56,671–72.

[234] *See* NASD CODE OF ARBITRATION PROCEDURE Rule 10308(c)(5) (National Ass'n of Sec. Dealers, Inc. 1999); *see also* Order Granting Approval to Proposed Rule Change Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, 63 Fed. Reg. at 56,671–72.

[235] *See* NASD CODE OF ARBITRATION PROCEDURE Rule 10308(c)(5) (National Ass'n of Sec. Dealers, Inc. 1999); *see also* Order Granting Approval to Proposed Rule Change Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, 63 Fed. Reg. at 56,672.

prohibit any person employed by an attorney or other professional devoting fifty percent or more of her work effort to the representation of investors in disputes with members of the securities industry from serving as chairperson.[236] Such an individual could be appointed as chairperson by the Director of Arbitration only if all public arbitrators on the panel "devote . . . [fifty percent] or more of [their] professional or business activities, within the last two years, to representing or advising [investors] in matters relating to disputed securities or commodities transactions or similar matters."[237]

It seems that this rule assumes that securities industry respondents would not be treated fairly if an attorney or other professional primarily representing investors is appointed as chairperson of an NASD arbitration panel. If the securities industry perceives that its members would not be treated fairly if *only* the chairperson represents primarily investors in securities disputes, surely it can concede that investors might reasonably perceive that they too cannot be treated fairly in a securities industry sponsored, funded, and controlled arbitral forum. Presently, the securities industry determines who is allowed into the pool of arbitrators from which both public and securities industry arbitrators are chosen, has some discretion in determining which of the arbitrators are appointed to serve on arbitration panels from this securities industry-selected pool of arbitrators, and decides all challenges for cause to its decisions as to which arbitrators are appointed from its pool of arbitrators. Even though amended NASD Rule 10308 allows investor participation in the arbitrator selection process, it seems that the NASD is attempting to reduce the impact of investor participation by prohibiting a perceived advantage that investors might have resulting from the appointment of chairpersons who primarily represent investors in securities disputes.

Thus, the NASD seems to believe that "fairness" requires precluding those who primarily represent investors in disputes with the securities industry from serving as chairpersons. Under prior NASD Rule 10308, there was no such prohibition, and the Director of Arbitration appointed the chairperson without restrictions.[238] In addition, while under the prior

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[236] *See* Notice of Filing of Proposed Rule Change Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, Exchange Act Release No. 34-40,261, 63 Fed. Reg. 40,761, 40,772 (1998).

[237] NASD CODE OF ARBITRATION PROCEDURE Rule 10308(c)(5)(B), (C); *see also* Order Granting Approval to Proposed Rule Change Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, 63 Fed. Reg., at 56,671.

[238] *See* NASD CODE OF ARBITRATION PROCEDURE Rule 10308 (National Ass'n of

arbitrator selection process NASD Rule 10308 provided that the Director of Arbitration *may* appoint the chairperson, amended NASD Rule 10308 states unequivocally that the Director of Arbitration *shall* appoint the chairperson of the panel if the parties are unable to agree on a chairperson within a mere fifteen days. It would seem that in order to dispel any perception of securities industry bias or domination, such an attorney or professional *should* be appointed as chairperson of the arbitration panel in a securities industry sponsored and administered arbitral forum. Moreover, in light of the fact that the Commission asserts that all arbitrators appointed to serve on arbitration panels in securities industry sponsored arbitration forums, whether classified as public or securities industry arbitrators, must be impartial,[239] this provision of amended NASD Rule 10308 is unnecessary. In addition, this provision of amended NASD Rule 10308 would prohibit the Director of Arbitration from appointing as chairperson all PIABA members and expert witnesses who primarily represent investors in adversarial proceedings concerning disputed securities or commodities transactions, unless all public arbitrators appointed to the panel primarily represented investors in such matters.

7. *Arbitrator Disqualification and Removal*

An arbitrator may be disqualified under amended NASD Rule 10308 if a party or the Director of Arbitration objects to continued service after the arbitrator has been appointed to serve on a panel but before the initial prehearing or hearing, whichever occurs first.[240] During this period, the Director of Arbitration has the sole authority to decide whether an arbitrator may be disqualified. This is virtually the same authority given to the Director of Arbitration under prior NASD Rule 10308.[241] The AAA

Sec. Dealers, Inc. 1997) (amended 1998).

[239] *See* Order Approving Proposed Rule Changes by the New York Stock Exchange, Inc., National Association of Securities Dealers, Inc., and the American Stock Exchange, Inc. Relating to the Arbitration Process and the Use of Predispute Arbitration Clauses, Exchange Act Release No. 34-26,805, 54 Fed. Reg. 21,144, 21,145-46 (1989).

[240] *See* NASD CODE OF ARBITRATION PROCEDURE Rule 10308(d)(1) (National Ass'n of Sec. Dealers, Inc. 1999); *see also* Notice of Filing of Proposed Rule Change Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, 63 Fed. Reg. 40,772 at 40,763.

[241] *See* NASD CODE OF ARBITRATION PROCEDURE Rule 10312(d) (National Ass'n of Sec. Dealers, Inc. 1997) (amended 1998); *see also* Notice of Filing of Proposed Rule Change Relating to the Selection of Arbitrators in Arbitrations Involving Public

also gives its staff this authority but only if a party objects to the continued service of an arbitrator. However, the parties can override the Director of Arbitration's decision to disqualify an arbitrator if they unanimously agree, in writing, that the arbitrator should be allowed to serve.[242] The authority of the Director of Arbitration to remove an arbitrator from the panel ends after the commencement of the first prehearing conference or the first hearing, whichever occurs first.[243]

Vacancies resulting from disqualification are filled by referring to the consolidated lists from which the panel was originally appointed and selecting the most highly ranked available arbitrator.[244] If no names remain on the consolidated list, the Director of Arbitration may only appoint a public arbitrator from the NASD arbitrator pool, unless the parties agree to a different panel composition.[245] As previously discussed, at this stage of the proceedings, the Director of Arbitration's unilateral decision may be overturned only if parties unanimously agree, in writing, within fifteen days after being notified of the Director of Arbitration's decision.[246]

Customers, 63 Fed. Reg. at 40,763.

[242] *See* NASD CODE OF ARBITRATION PROCEDURE Rule 10308(d)(1) (National Ass'n of Sec. Dealers, Inc. 1999); *see also* Notice of Filing of Proposed Rule Change Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, 63 Fed. Reg. at 40,763.

[243] *See* NASD CODE OF ARBITRATION PROCEDURE Rule 10308(d)(2) (National Ass'n of Sec. Dealers, Inc. 1999); *see also* Notice of Filing of Proposed Rule Change Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, 63 Fed. Reg. at 40,763.

[244] *See* NASD CODE OF ARBITRATION PROCEDURE Rule 10308(d)(3) (National Ass'n of Sec. Dealers, Inc. 1999); *see also* Order Granting Approval to Proposed Rule Change Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, Exchange Act Release No. 34-40,555, 63 Fed. Reg. 56,672 (1998).

[245] *See* NASD CODE OF ARBITRATION PROCEDURE Rules 10308(c)(4)(B), (d)(3) (National Ass'n of Sec. Dealers, Inc. 1999); *see also* Order Granting Approval to Proposed Rule Change Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, 63 Fed. Reg. at 56,671-72.

[246] *See* NASD CODE OF ARBITRATION PROCEDURE Rule 10308(d)(1) (National Ass'n of Sec. Dealers, Inc. 1999); *see also* Notice of Filing of Proposed Rule Change Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, 63 Fed. Reg. at 40,763.

C. *Unfettered Securities Industry Discretion*

The Director of Arbitration is given explicit authority to exercise her discretion in the arbitrator selection process under paragraph (e) of amended NASD Rule 10308. Although not expressly stated in the text of paragraph (e) of amended NASD Rule 10308, its Commentary provides that the Director of Arbitration may exercise this discretionary authority only if circumstances arise in which amended NASD Rule 10308 "does not have an applicable provision" or "the application of a specific provision" of amended NASD Rule 10308 would not resolve an "underlying problem" because of "unanticipated or unusual" circumstances.[247] This type of blanket authority in the arbitrator selection process does not exist, and is not considered necessary, in the AAA Code. Moreover, the text of amended NASD Rule 10308 seems to go further in that it authorizes the Director of Arbitration to "make any decision that is consistent with [the NASD's Code of Arbitration Procedure] to facilitate the appointment of arbitration panels and the *resolution of arbitration disputes*."[248] Paragraph (e) reasonably may be perceived as undermining the NASD's goal of alleviating investor perception that the NASD arbitrator selection process is biased in favor of the securities industry because it gives such blanket authority to the securities industry in the NASD arbitral forum.

V. INVESTOR PERCEPTION OF A PRO-SECURITIES INDUSTRY BIAS

Amended NASD Rule 10308 is ineffective in lessening investor perception that the NASD's arbitrator selection process is biased in favor of the securities industry. There is likely to remain an appearance of impropriety in the arbitrator selection process because of ambiguity, under-inclusiveness, and over-inclusiveness in the arbitrator classification system combined with too much securities industry discretion in the appointment process of a securities industry sponsored and administered arbitral forum.

The arbitrator classification system under amended NASD Rule 10308 fails to address satisfactorily investor perception that the NASD arbitrator selection process is biased in favor of the securities industry. This perception persists because the arbitrator classification rules in amended

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[247] Notice of Filing of Proposed Rule Change Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, 63 Fed. Reg. at 40,773.

[248] NASD CODE OF ARBITRATION PROCEDURE Rule 10308(e) (National Ass'n of Sec. Dealers, Inc. 1999) (emphasis added).

NASD Rule 10308 easily result in misclassification of arbitrators in the NASD arbitrator pool. Arbitrator classification rules under amended NASD Rule 10308 are based on arbitrary assumptions causing its classification scheme to be under-inclusive, over-inclusive, ambiguous, and very difficult to enforce. For example, arbitrary time designations are used to determine whether an individual is likely to be perceived as biased in favor of the securities industry and therefore should be classified as a securities industry arbitrator. This results in the same person being classified as a securities industry arbitrator one year and as a public arbitrator the next year, regardless of actual bias. Amended NASD Rule 10308 assumes that those formerly associated with the securities industry cease to be biased in favor of the securities industry exactly three years after being so associated, unless such individuals retire from the securities industry; professionals such as attorneys and accountants cease to be biased in favor of the securities industry two years after devoting more than twenty percent of their work effort to securities clients. However, bank or financial institution employees who effect securities transactions, and their supervisors, cease to be biased in favor of the securities industry the moment they cease to be employed in the securities industry, i.e., in an instant. The use of such arbitrary time designations to determine the existence of pro-securities industry bias does not effectively alleviate investor concern that the NASD public arbitrator pool includes individuals affiliated with the securities industry.

Amended NASD Rule 10308 is ambiguous because it fails to define key terms and phrases used in the NASD's arbitrator classification system. For example, amended NASD Rule 10308 fails to define clearly the phrase "person who is otherwise qualified to serve as an arbitrator" as used in its definitions of public and securities industry arbitrators. This phrase in the definition of securities industry arbitrator seems to require securities industry experience, at least three years, to qualify to serve as a securities industry arbitrator in the NASD arbitrator pool. More importantly, it seems that public arbitrators are only "qualified to serve" if somehow formerly affiliated with the securities industry but sufficiently removed from the securities industry to cease being biased in favor of the securities industry—three years after terminating employment in the securities industry, if a person did not retire from the securities industry. This makes individuals classified as public arbitrators in the NASD arbitrator pool even more suspect. Moreover, use of this phrase seems to confirm the perception of investors that the NASD public arbitrator pool includes arbitrators affiliated with the securities industry.

The arbitrator classification system under amended NASD Rule 10308 continues to permit the firms of professionals to represent the securities industry with impunity, while classifying the individual professional at the firm as a public arbitrator in the NASD arbitrator pool. Amended NASD Rule 10308 completely ignores the fact that economic ties between partners reasonably may give rise to an appearance of bias in favor of the securities industry in its public arbitrator pool; curiously, this fact is recognized in the context of spouses and immediate family members of those employed in the securities industry. In addition, amended NASD Rule 10308 persists in erroneously classifying investment advisers as public arbitrators, even though they are clearly an integral part of the securities industry.

Finally and most importantly, amended NASD Rule 10308 points out the difficulty, maybe the impossibility, of eliminating the perception of pro-securities industry bias in the NASD arbitrator pool when an economically dependent relationship exists between one of the parties (securities industry respondents) and the arbitrators deciding the dispute. This is especially so in light of the fact that the securities industry also drafts the agreement requiring investors to arbitrate future disputes in a securities industry sponsored and administered forum, e.g., the NASD arbitral forum. Specifically, the NASD has acknowledged in its arbitrator selection rules and its related Commentary that immediate family members who have an economically dependent relationship with a member of the securities industry are precluded from serving as either securities industry or public arbitrators because they "may be viewed as possessing a bias in favor of the securities or commodities industry."[249] It is clear that the NASD arbitrator selection process is administered by an arbitral forum that is economically dependent on the securities industry; the NASD arbitral forum is primarily funded by a securities industry association (the NASD) which is supported by the payment of dues from its members—securities industry firms. In addition, the NASD remains the sole arbiter of who is admitted in its arbitrator pool and whether they are classified as public or securities industry arbitrators. Standards governing admittance to the NASD arbitrator pool remain a mystery. Moreover, the fact that the NASD controls admission and classification of individuals in its arbitrator pool may result in its arbitrator selection process being perceived as biased in favor of the securities industry no matter how its classification rules are crafted. Accordingly, investors' perceptions that the arbitrator selection process is biased in favor of the securities industry is quite reasonable, if

[249] Notice of Filing of Proposed Rule Change Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, 63 Fed. Reg. at 40,767.

not inevitable.

The arbitrator appointment process in amended NASD Rule 10308 does not permit arbitrators to be chosen primarily by the parties rather than by the securities industry. Too much securities industry discretion remains in the arbitrator appointment process. Although a software program, NLSS, is used to choose the names of arbitrators from the NASD arbitrator pool, NASD staff discretion is interposed before lists of arbitrators are forwarded to the parties for ranking. NASD staff perform a manual review for conflicts of interest after arbitrators have been selected from the NASD pool of arbitrators using NLSS but before these lists of arbitrators are forwarded to the parties for ranking. This means that NASD staff may remove an arbitrator, selected on a rotational basis, from a list before the list is sent to the parties for ranking. But the purpose of generating lists using NLSS on a rotational basis is to remove NASD staff, and therefore securities industry discretion, from the arbitrator appointment process at an early stage of the proceedings, i.e., "to divest the NASD of its power to select arbitrators on a case-by-case basis."[250] Allowing NASD staff to remove arbitrators on the list in their sole discretion undermines this process and simply fuels the perception by investors that the arbitrator selection process is biased in favor of the securities industry.

The NASD states that this review is necessary because NLSS is limited in the types of conflicts of interests that it can identify. However, amended NASD Rule 10308 fails to disclose fully the types of conflicts of interests that NLSS is capable of identifying. The Commentary only identifies two such conflicts of interest.[251] In addition, neither amended NASD Rule 10308 nor its Commentary disclose how arbitrators currently in the NASD arbitrator pool, or added subsequently, would be initially positioned in the NLSS database. Without such disclosure, investors reasonably may perceive that manipulation of the arbitrator pool results in an arbitrator selection process that is biased in favor of the securities industry.

Amended NASD Rule 10308 also allows securities industry discretion in the arbitrator ranking process. As a result, the outcome is not determined primarily by the parties. If a party fails to rank or assigns the same numerical ranking to an arbitrator on a list, the Director of Arbitration ranks such arbitrators on behalf of a party. Moreover, the Director of Arbitration is required to assume that the parties intended to rank such arbitrators. For example, if a party fails to rank two or more arbitrators on

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[250] Bernstein, *supra* note 152, at 17.

[251] *See* Notice of Filing of Proposed Rule Change Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, 63 Fed. Reg. at 40,761.

the same list or gives two or more arbitrators on the same list the same numerical ranking, the Director of Arbitration ranks the multiple, unranked arbitrators and the arbitrators with the same numerical ranking in the same order of preference in which they appeared on the original list sent to the parties generated by NLSS and manually reviewed by NASD staff. This procedure requires the Director of Arbitration to assume that the parties would have ranked the arbitrators in a certain manner. This particular procedure allows securities industry discretion in the ranking process of the parties because it substitutes NASD staff judgment for the judgment of the parties.

The decisions of the parties in the appointment process can again be circumvented by the securities industry when arbitrators on the lists ranked by the parties are contacted to determine whether they are available to serve on a panel. When contacting arbitrators on the lists, only the Director of Arbitration determines whether to disqualify the arbitrator based on information obtained during this initial contact. This means that the parties' choices, and thus their participation, may be diminished greatly at this stage of the arbitrator selection process. Arbitrators ranked highest by the parties may not be appointed to serve on the panel, despite their availability. Disclosing such information to the parties for a determination as to whether the disclosed relationship or interest rises to the level that it would preclude the arbitrator from rendering an impartial decision probably would be more appropriate.

If the list selection process fails to complete a panel, arbitrators are selected by NASD staff rather than by the parties. Amended NASD Rule 10308 allows the Director of Arbitration to appoint arbitrators not on a consolidated list if the number of arbitrators available to serve from a consolidated list is insufficient to complete a panel. If the parties strike all the names on the list, the Director of Arbitration essentially determines which arbitrators will serve on the panel; parties may request only that the arbitrator selected by the Director of Arbitration be disqualified. But permitting the parties only to request the disqualification of an arbitrator appointed in the sole discretion of the Director of Arbitration does not facilitate the selection of arbitrators primarily by the parties. This procedure only fuels investor perception that the NASD arbitrator selection process is biased in favor of the securities industry.

Despite NASD protestations that amended NASD Rule 10308 permits selection of arbitrators primarily by the parties rather than the securities industry, the NASD seemingly attempts to undermine the participation of parties who are investors when appointing the chairperson of arbitrator

panels. If the parties cannot agree on whom to appoint as chairperson within fifteen days of being notified of the names of arbitrators appointed to the panel, the Director of Arbitration appoints a public arbitrator as chairperson. However, amended NASD Rule 10308 prohibits the Director of Arbitration from appointing as chairperson a public arbitrator who devotes fifty percent or more of her work effort, within the last two years, to investors involved in disputes with the securities industry. This rule assumes that any person representing investors fifty percent or more of her time is biased in favor of investors to the extent that it would not be "fair" to securities industry respondents to allow such a person to serve as chairperson. This assumption is unfounded. The securities industry controls the pool from which arbitrators are selected to serve on the panel, and it has control at the very beginning of the arbitrator selection process by limiting the universe of choices by the parties. Moreover, there are numerous opportunities, as previously discussed, for the exercise of NASD staff discretion throughout the arbitrator appointment process. This particular section of amended NASD Rule 10308 will, probably more than any other, fuel the perception of investors that the arbitrator selection process, including the entire securities industry sponsored arbitration process, is dominated, controlled, and biased in favor of the securities industry.

Finally, subsection (e) of amended NASD Rule 10308 appears to give the industry unfettered discretion, not only in the arbitrator selection process, but also in the entire NASD arbitration process. Accordingly, it may be perceived by investors as undermining party participation in the arbitrator selection process enumerated elsewhere in amended NASD Rule 10308. It is essential that the selection of the decisionmaker, i.e., the arbitrator, in securities industry sponsored arbitration proceedings be perceived as fair and impartial. Even the perception by investors that the securities industry dominates the arbitrator selection process can destroy the credibility of the NASD arbitral forum.

VI. CONCLUSION

Although the list selection method of appointing arbitrators in amended NASD Rule 10308 is a significant step in reducing NASD staff discretion in the arbitrator selection process, it will never be enough to eliminate investor perception that NASD arbitrators are biased in favor of the securities industry. In situations where there are questions about the impartiality of a decisionmaker, enhancing procedures to select arbitrators

will never be sufficient to assure participants that the arbitrators are independent.[252] The selection of arbitrators in the NASD arbitral forum is just such a situation. Even though investors now participate by using a list selection method, the arbitrator selection process remains subject to NASD staff, and therefore securities industry, discretion because it is administered by the NASD, a securities industry member association funded by the dues of its membership.[253] Moreover, the securities industry controls the group and classification of individuals allowed to serve as NASD arbitrators. This means that the securities industry determines who is admitted to the available arbitrator pool and whether arbitrators in its arbitrator pool are classified as public or securities industry arbitrators. Investors only participate in the arbitrator selection process after the securities industry has determined, in rules it promulgates,[254] who gets to be an arbitrator and whether an arbitrator is classified as public or securities industry.

The equitable selection of arbitrators is essential to the success of the NASD arbitral forum. As presently constituted, there is a valid perception that NASD arbitrators are not impartial or independent of the securities industry. Moreover, investors do not have an equal right to control the appointment of the arbitral panel; currently, NASD staff plays a disproportionate role in selecting arbitrators in the NASD arbitral forum. Accordingly, the NASD arbitrator selection process is reasonably perceived by investors as, at least, institutionally linked to the securities industry. Moreover, investors do not have a choice in selecting a more acceptable arbitrator selection process or arbitral forum. Generally, they are required by a contract drafted by the securities industry, which they must sign in order to do business with the securities industry, to use only a securities industry forum; in most cases, this is the NASD arbitral forum.[255]

The selection of arbitrators in securities arbitration should be done by a truly independent group. The author recommends that, at least, the selection of arbitrators should be administered by the AAA. This is not a novel idea. Even the Commission has suggested to the securities industry

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[252] *See* Allison, *supra* note 70, at 482.

[253] The formation of an "independent," wholly-owned subsidiary to administer the NASD arbitral forum does not negate the fact that the NASD arbitral forum is sponsored, funded, and administered by the securities industry.

[254] The author recognizes that rules promulgated by the NASD are subject to Commission review and approval.

[255] The author recognizes that some contracts allow investors to use the so-called "AMEX Window" which allows investors to arbitrate disputes with the securities industry using the AAA arbitral forum.

that investors should be given the option of arbitrating disputes with members of the securities industry in the AAA arbitral forum. As previously noted, even though the AAA rules governing the selection of arbitrators are similar and, in many ways, just as ambiguous as the NASD rules, investors perceive the AAA arbitral forum to be independent and not biased in favor of the securities industry. Allowing investors to have the AAA option, at least for the selection of arbitrators, "deflects the contention that the public is being forced into an industry sponsored SRO forum, and thus enhances the image of fairness of the arbitration process."[256] Moreover, fairness dictates that investors should have at least persons designated as public arbitrators who are truly independent of the securities industry.

The author contends that the implementation of a list selection method for selecting arbitrators' addresses is at best only half of the problem because the NASD continues to control who is admitted to the pool of arbitrators; the arbitrators placed on lists under the new list selection method can be selected only from the NASD-controlled pool of arbitrators. Moreover, if a complete panel cannot be appointed from the lists submitted to the parties, the NASD again appoints arbitrators to the list in its sole discretion. It is strongly recommended that the selection of arbitrators in investor disputes be removed from the NASD arbitral forum and transferred to an independent arbitral forum such as the AAA. Investors' confidence in securities arbitration depends on at least the perception of the fairness and impartiality of the arbitrators deciding their disputes. Investors most likely will always perceive NASD arbitrators to be biased until the arbitrator selection method is perceived as fair in fact and appearance. "[J]ustice should not only be done, but should manifestly and undoubtedly be seen to be done."[257] Until this is achieved, the NASD will continue to strive for an elusive goal, i.e., proving to investors that its securities industry controlled arbitrator selection process results in arbitration proceedings that are "fair to all parties."

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[256] Katsoris, *supra* note 3, at 525.

[257] Katsoris, *supra* note 2, at 310 (quoting Richards v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 135 Cal. Rptr. 26, 28 (Cal. Ct. App. 1976) (quoting The King v. Sussex Justices, 1 K. B. 256, 259 (1924))).